No getting around the 50% entertainment rule

The Federal Court of Appeal released its decision last month in a case that could have broad implications for the allowance of certain types of business entertaining expenses.

The appeal case involved Mark Stapley, a self-employed real estate agent, who deducted between $14,000 and $20,000 of meals and entertainment expenses in the years 2000, 2001 and 2002. Mr. Stapley did not actually consume any food or attend any entertainment events with his clients, but gave them vouchers or tickets to use as they wished.

Mr. Stapley claimed the full cost of these vouchers and tickets on his tax returns as business expenses incurred to reward clients and encourage them to send him more business.

Under Canada's tax laws you can deduct legitimate business expenses incurred for the purpose of earning income, as long as the expenses are reasonable and are not considered personal or living expenses. An exception to this rule exists for business meals or entertainment; only 50% of these expenses are tax deductible. The reasoning is a business person receives some degree of personal enjoyment from the meal or entertainment.

The Canada Revenue Agency (CRA) applied the 50% rule to Mr. Stapley's meals and entertainment expenses. According to the CRA, nothing in the wording of the Tax Act "limits the application of the provision to situations in which the taxpayer participated in the consumption of the food or beverages or in the enjoyment of the entertainment."

However, the lower Tax Court judge disagreed and concluded Mr. Stapley's purchases "were for the purpose of, or in respect of, earning income from his business, and not consumption or entertainment." He allowed the full amounts to be deducted.

But the Federal Court of Appeal sided with the CRA and concluded that, "the plain wording of the... [rule] suggests that there is no requirement of taxpayer use." As a result, the 50% limitation applied.

In justifying its finding, the Appeal Court set out what it referred to as the "mischief sought to be cured" by the 50% rule on food and entertainment expenses. The Court explained that, without this rule, a taxpayer may be tempted to consider the cost of a "business" lunch eaten with a client as a fully-deductible business expense rather than a non-deductible personal one.

The Court was sympathetic to Mr. Stapley's predicament, however. As the judge wrote, "it seems unfair to cut the respondent's deductions in half. The respondent could have purchased flowers or books for his clients and deducted 100% of their costs... Thus, in its current form, [the 50% restriction] interferes with taxpayers' business decisions and in particular, how they allocate their marketing budgets."

It certainly does seem illogical that if Mr. Stapley were to have written a cheque to his clients for $200 to go out for dinner instead of giving his clients the restaurant gift certificates, he would have been able to fully deduct the $200.

This case calls out to government to correct the inequity between fully deductible, legitimate business gifts, and the 50% rule on gifts of meals and entertainment.

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