Travel and Entertainment: Maximizing The Tax Benefits

Don’t overpay your income taxes by overlooking expenses which you are entitled to deduct. Use this Financial Guide to ensure you are handling your business travel and entertainment costs in a tax-wise manner.

This Financial Guide shows you how to take all of the travel and entertainment expenses you’re entitled to. It tells you which expenses are deductible and what percentage of them you can deduct, and it familiarizes you with the IRS’ rules for keeping records and substantiating your expenses.

Travel Expenses

The tax law allows you to deduct two types of travel expenses related to your business.

1. Firstly you can deduct local transportation expenses incurred for business purposes—the expense of getting from one location to another, but not meals or incidentals.
2. Second, you can deduct away from home travel expenses—including meals and incidentals. Deduction limits can be eased if your employer reimburses your travel expenses.

Local Transportation Costs

You can deduct the cost of local business transportation. This includes airfare, rail fare, and bus fare, as well as the costs of using and maintaining a business automobile. For those whose main place of business is their personal residence, business trips from that residence, and return trips, are deductible transportation and not non-deductible commuting.

Note: Please see the special section below for the most effective ways of deducting Auto Expenses

You generally cannot deduct lodging and meals unless you stay away overnight. Meals may be partially deductible as an entertainment expense, as discussed below.

Away From-Home Travel Expenses

You can deduct one-half of the cost of meals and all of the expenses of lodging incurred while traveling away from home.

To be deductible, travel expenses must be "ordinary and necessary"—though "necessary" is liberally defined as "helpful and appropriate", not "indispensable". Deduction is also denied for that part of any travel expense that is "lavish or extravagant", though this rule does not bar deducting the cost of first class travel, or deluxe accommodations or (subject to percentage limitations below) deluxe meals.

What does "away from home" mean? To deduct the costs of lodging and meals (and incidentals—see below) you must generally stay somewhere overnight. Otherwise, your costs are considered local transportation costs, and the costs of lodging and meals are not deductible.

Where is your "home" for tax purposes? The general view is that your "home" for travel expense purposes is your place of business or your post of duty. It is not where your family lives. (Some courts say it's the general area of your residence).

Example: George's family lives in Boston and George works in Washington, DC. George spends the weekends in Boston and the weekdays in Washington, where he stays in a hotel and eats out. George's tax home is Washington, DC—not Boston. Therefore, he cannot deduct any of the following expenses: the costs of traveling back and forth between Washington and Boston, the costs of eating out in Washington, the costs of staying in a hotel in Washington, and the costs of traveling between his hotel in Washington and his job in Washington (the latter are non-deductible commuting costs). The reason: For tax purposes, his "home" is in Washington.

There are some tricky rules in the tax law concerning where a taxpayer's "home" is for purposes of deducting travel expenses. They come up whenever a taxpayer works at a temporary site, or works in two different places.

We'll cover these rules briefly in these examples:

Example: Joe, who lives in Connecticut, works eight months out of the year in Connecticut (from which he usually earns about $50,000) and four months out of the year in Florida (from which he usually earns about $15,000). Joe's "tax home" for travel expense purposes is Connecticut. Therefore, the costs of traveling to and from the "lesser" place of employment (Florida), as well as meals and lodging costs incurred while working in Florida, are deductible.

Example: Susan works and lives in New York. Occasionally, she must travel to Maryland on temporary assignments, where she spends up to a week at a time. Result: She can deduct the costs of meals and lodging while she's in Maryland, as well as the costs of traveling to and from Maryland. The reason: The work assignments in Maryland are temporary, since they will end within a foreseeable time. (Assignments that are realistically expected to last for more than a year are indefinite, not temporary.) If an assignment is considered indefinite under the tax law, travel, meal, and lodging costs are not deductible.

Here's a list of some deductible away-from-home travel expenses:

- Meals (limited to 50%) and lodging while traveling or once you get to your away-from-home business destination.
- The cost of having your clothes cleaned and pressed away from home.
- Costs for telephone, fax or modem usage.
- Costs for secretarial services away-from-home.
- The costs of transportation between job sites or to and from hotels and terminals.

- Airfare, bus fare, rail fare, and charges related to shipping baggage or taking it with you.
- The cost of bringing or sending samples or displays, and of renting sample display rooms.
- The costs of keeping and operating a car, including garaging costs.
- The cost of keeping and operating an airplane, including hangar costs.
- Transportation costs between "temporary" job sites and hotels and restaurants.
- Incidentals, including computer rentals, stenographers' fees.
- Tips related to the above.

However, many away-from-home travel expenses are not deductible or are restricted in some way. These include:

- *Commuting expenses.* The costs of traveling between your home and your job are not deductible.
- *Travel as a form of education.* Trips that are educational in a general way, or improve knowledge of a certain field but are not part of a taxpayer’s job, are not deductible.
- *Costs of looking for a first job.* If you are looking for a new job in your current field, you can deduct the travel expenses. Otherwise, you may not deduct them.
- *Seeking a new location.* Travel costs (and other costs) incurred while you are looking for a new place for your business, or for a new business, must be capitalized and cannot be deducted currently.
- *Luxury water travel:* If you travel using an ocean liner, a cruise ship, or some other type of "luxury" water transportation, the amount you can deduct is subject to a per-day limit.
- *Seeking foreign customers:* The costs of traveling abroad to find foreign markets for existing products are deductible.

Tip: The travel (and other) costs incurred in unsuccessfully trying to acquire a specific business are currently deductible.

Entertainment Expenses

There are limits and restrictions on the deductibility of entertainment expenses. For employees who are "fully reimbursed" (see below), the limits are imposed on the employer, not the employee. Entertainment must be either directly related to your business or associated with it, and must be substantiated. (We’ll cover this below.)

Only half of entertainment expenses and business meals are deductible. Further, meals and entertainment must be "ordinary and necessary" and not "lavish or extravagant." Please see the **away from home travel expense on the self employed page** discussion for more on these rules.

If you entertain at home, you don’t get a deduction for whatever it would have cost to feed and/or entertain yourself and your family.

Rentals for skyboxes and other luxury boxes face a double limitation. If the rental covers more than one event, you can’t take into account more than the cost of a non-luxury box seat (per person, per event). Deduction for those seats is then subject to the 50%

entertainment expense limit.

Deductions are disallowed for depreciation and upkeep of "entertainment facilities"—yachts, hunting lodges, fishing camps, swimming pools, and tennis courts. Costs of entertainment provided at such facilities are deductible subject to entertainment expense limitations.

Dues paid to country clubs or to social or athletic clubs are not deductible. Dues you pay to professional and civic organizations are deductible as long as your membership has a business purpose. Such organizations include business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

Tip: To avoid problems qualifying for a deduction for dues paid to professional or civic organizations, document the business reasons for the membership—the contacts you make and any income generated from the membership.

Entertainment costs, taxes, tips, cover charges, room rentals, maids and waiters are all subject to the 50% limit on entertainment deductions.

How Do You Prove Expenses Are "Directly Related"?

Expenses are directly related if you can show:

- There was more than a general expectation of gaining some business benefit other than goodwill.
- You conducted business during the entertainment.
- Active conduct of business was your main purpose.

There is a presumption (in the eyes of the IRS) that events that take place in what it considers places non-conducive to doing business are not directly related to your business. These places include nightclubs, theaters, sporting events or cocktail parties. It also includes meetings with a group of people who are not business associates, at cocktail lounges, country clubs, or athletic clubs. However, you can overcome the presumption by showing that you engaged in a business discussion or otherwise conducted business during the event.

How Do You Meet The "Associated With" Test?

Even if you can’t show that the entertainment was "directly related" as discussed above, you can still deduct the expenses as long as you can prove the entertainment was "associated" with your business. To meet this test, the entertainment must directly precede or come after a substantial business discussion. Further, you must have had a clear business purpose when you took on the expense.

For Whom Can You Get The Deduction?

The person entertained must be a business associate—someone who could reasonably be expected to be a customer or conduct business with you, including an employee or professional advisor.

In circumstances where it's customary to entertain a business associate with his or her spouse, and your spouse also attends, entertainment of both spouses is deductible.

Recordkeeping And Substantiation Requirements

The tax law requires you to keep records that will prove the business purpose and amounts of your business travel, entertainment, and local transportation costs.

Which Records You Must Keep

You must substantiate the following business expenses:

- Travel expenses while away from home (including meals and lodging).
- Entertainment and arranging recreational activities, and
- Business gifts.

To substantiate these items, you must prove:

- The amount.
- The time and place of the travel, entertainment, or recreation, or the date and a description of the business gift.
- The business purpose, and
- The business relationship of the recipient of entertainment or gifts.

Tip: The most frequent reason for IRS's disallowance of T&E expenses is the failure to show the place and business purpose of an item. Therefore, pay special attention to these aspects of your record-keeping. Keep a diary or log book. Each expense for lodging away from home, as well as each other type of expense away from home for $75 or more, must be supported by receipts. The receipt must show the amount, date, place and character of the expense. Make the entries at or close to the time the expense is incurred.

Here's how these rules apply to your record-keeping for travel expenses, entertainment expenses, and business gifts.

Away-from-home travel expenses. You must document the following for each trip:

- The amount of each expense—e.g., the cost of each transportation, lodging and meal. (You can group similar types of incidentals together—i.e., "meals," "taxis.")
- The dates of your departure and return and the number of days you spent on

business.

- Your destination.
- The business reason for the travel or the business benefit you expect.

Entertainment expenses. You must prove the following for each claimed deduction for entertainment expenses:

- The amount of each separate expense, though incidentals may be totaled on a daily basis.
- The date of the entertainment.
- The name, address, and type of entertainment—e.g., "dinner," or "show"—but only if the type of entertainment is not obvious from the place name.
- The business reason for the entertainment and the nature of any business discussion that took place. Note: For business meals, you do not have to write down the nature of the discussion, but you or your employee must be present.
- The name, title, and occupation (showing business relation) of the people you entertained.

Business gifts. You must keep the following documentation for a business gift to substantiate the deduction:

- The cost of the gift and the date it was made.
- The business reason for the gift.
- The name, title, and occupation of the recipient.
- A description of the gift.

Employees "Fully Reimbursed"

Employees who are "fully reimbursed" by their employers are not subject to the deduction limits discussed in this Financial Guide—their employers are. "Fully reimbursed" means that all the following occur:

- You adequately account to your employer (see below).
- You receive full reimbursement.
- You were required to, and did, return any excess reimbursement.
- In your Form W-2, Box 13 shows no amount with a Code L.

You adequately account to your employer by means of an expense account statement. If you are covered by (and follow) an "accountable plan," and your reimbursements don't exceed your expenses, you won't have to report the reimbursements as gross income. Some per diem arrangements (by which you receive a flat amount per day) and mileage allowances can avoid detailed expense accounting to the employer, but proof of time, place and business purpose is still required. However, if your employer's reimbursement plan in not "accountable," you must report the reimbursements as income, and you can then deduct the expenses you paid—but you must deduct them as employee business expenses, subject to the 2%-of-adjusted-gross-income floor.

If you are reimbursed under an expense account for travel, transportation, entertainment, gifts, and other business expenses, here are the record-keeping and reporting rules that apply.If you are reimbursed under an expense account for travel, transportation, entertainment, gifts, and other business expenses, here are the record-keeping and reporting rules that apply.

If you are covered by (and follow) an "accountable plan," and your reimbursements don't exceed your expenses, you won't have to report the reimbursements as gross income. However, if your employer's reimbursement plan in not "accountable," you must report the reimbursements as income, and you can then deduct the expenses you paid—but you must deduct them as employee business expenses, subject to the 2%-of-adjusted-gross-income floor. An accountable plan is one in which (1) your expenses are business related, (2) you adequately account for these expenses to your employer within a reasonable time and (3) you return any excess reimbursement within a reasonable time.

Auto Expenses

Self-employed and employees who use their cars for business but either don't get reimbursed, or are reimbursed under an employer's "non-accountable" reimbursement plan can deduct auto expenses. In the case of employees, expenses are deductible to the extent that auto expenses (together with other "miscellaneous itemized deductions") exceed 2% of adjusted gross income.

If you use a car for business, you have two choices as to how to claim the deductions:

1. You can deduct the actual business-related costs of gas, oil, lubrication, repairs, tires, supplies, parking, tolls, chauffeur salaries, and depreciation.
2. You can use the standard mileage deduction—an inflation-adjusted amount that is multiplied by the number of business miles driven.

Tip: Parking fees and tolls may be deducted no matter which method you use.

For some, the standard mileage rate produces a larger deduction. Others fare better tax-wise by deducting actual expenses. After we tell you about limits on auto depreciation, we'll tell you how to determine which of these two methods is better for you tax-wise.

Expensing and depreciating vehicle costs. Deduction options and amounts depend on the percentage used for business. Assuming the car is used more than 50% for business, it can be included as business property qualifying for expensing (called the Section 179 deduction) in the year of purchase. The deduction is reduced proportionately to the extent the car is used for personal purposes. If you take this deduction you can't use the actual mileage for that vehicle in any year.

Depreciation. Assuming the car cost more than the Section 179 limit, or Section 179 is not available or is not claimed, depreciation is also allowed. Various depreciation options are available, and there are limits to the amount of depreciation that can be claimed per year.

Depreciation otherwise allowable is reduced by the proportion of personal use (a car used 20% for personal use is depreciated at 80% of the amount otherwise allowed). Accelerated depreciation—depreciation at a rate higher than that resulting from dividing the vehicle's cost by the number of years it will be used—is not allowed where personal use is 50% or more.

Finally, if you claimed accelerated depreciation in a prior year and your business use then falls to 50% or less, you become subject to "recapture" of the excess depreciation (i.e., it's included in income).

Of course, using the standard mileage deduction allows you to avoid these limits.

Determining whether to use the standard mileage deduction. If you opt for the standard mileage rate, you simply multiply current cents-per-mile rate by the number of business miles you drive for the year.

Be aware, however, that the standard mileage deduction may understate your costs. This is especially true for taxpayers who use the car 100% for business, or close to that percentage.

Caution: Once you choose the standard mileage rate, you cannot use accelerated depreciation even if you opt for the actual cost method in a later year. You may use only straight line.

Tip: The standard mileage method usually benefits taxpayers who have less expensive cars or who travel a large number of business miles To determine which method is better for you, make the calculations each way during the first year you use the car for business.

You may use the standard mileage for leased cars if you use it for the entire lease period. Or, you can deduct actual expenses instead, including leasing costs.

Recordkeeping. This is one thing you can do to make the most of your auto deductions. You won't be able to determine which of the two options is better if you don't know the number of miles driven and the total amount you spent on the car. Furthermore, the tax law requires that you keep travel expense records and that you give information on your return showing business versus personal use. If you use the actual cost method, you'll have to keep receipts.

Tip: Consider using a separate credit card for business to simplify your record-keeping.

Tip: Don't forget to deduct the interest you pay to finance a business-use car if you're self-employed.