76 Ways to Maximize Expense Account Deductions

From the editors of TAX STRATEGIES
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Introduction: Making Your T&E Deductions Stick

To politicians and the press, business travel and entertainment are synonymous with the “three-martini lunch”: You go out and have a good time, then stagger back to the office with a signed contract in your pocket.

But you know better. Business T&E is hard work. Sometimes it pays off, sometimes it doesn’t. Either way, you want to maximize your tax deductions. Of course, the line between business and personal T&E sometimes blurs. A business lunch can become an enjoyable social occasion; a family vacation can turn into a round of business meetings and sales calls.

This special report will show you where to draw the line. Yes, take all the T&E deductions to which you’re entitled. But don’t abuse the privilege and trigger an IRS audit. As you thumb through these pages, you’ll find a complete reference guide to deductible expenses and a rundown on all the records you must keep to substantiate your claimed write-offs.

Be sure to take the time to review this report carefully. You pay enough taxes already. There’s no need to add to your bill by stumbling over IRS penalties or by overlooking crucial write-offs.

Section I: What’s Deductible or Not

Travel Expenses

You can deduct the costs incurred in traveling away from home on business (including 50% of meals and 100% of lodging) and costs for local transportation on business.

But be careful. For tax purposes, there’s a difference between out-of-town travel expenses and local transportation expenses. Local transportation expenses involve only the costs of travel (not including meals and lodging) that relate directly to the actual conduct of a trade or business while not away from home. Let’s start off by covering away-from-home travel expenses.

Travel expenses in pursuit of a trade or business

Travel expenses (including meals, lodging and other defined incidentals) are ordinary and necessary costs you ring up while traveling away from home on business. These expenses include:

- Meals (subject to the 50% rule) and lodging, both en route and at the destination.
• Air, rail and bus fares and baggage charges.
• Cost of transporting sample cases or display materials.
• Expenses for sample display rooms.
• Cost of maintaining and operating a car.
• Cost of maintaining and operating an airplane (including depreciation on an airplane hangar).
• Reasonable cleaning and laundry expenses.
• Telephone and fax expenses.
• Cost of a public stenographer.
• Cost of transportation from an airline, train or bus terminal to the hotel, from the hotel to the terminal, or between customer or work sites.
• Reasonable transportation costs between restaurants or hotels and temporary work sites.
• Tips and other incidental travel expenses.

Travel expenses and income production
You’re entitled to write off ordinary and necessary expenses that you incur to produce or collect income, to manage or maintain income-producing property or to calculate or collect a tax refund.

If you take a cab to your broker’s office for a consultation, for example, you can deduct the fare. As a general rule, though, you can’t deduct the cost of traveling to company stockholder meetings if you’re a shareholder.

Investment seminars and conventions
The tax law prohibits deductions for the costs of attending conventions, seminars or similar meetings for investment or income-producing purposes (so-called Section 212 expenses) unrelated to your trade or business. That means you can’t deduct registration fees or travel, transportation, meal or lodging costs.

Caution: Don’t try to write off T&E costs for a business convention where you merely received a video of lectures and seminars that you can view later at your leisure. As far as the IRS is concerned, that’s a personal vacation in disguise.

Travel as a form of education
Tough restrictions are imposed on deducting the cost of so-called “educational” trips. For example, a Spanish teacher who uses his summer vacation to travel to Spain to improve his knowledge of the culture and language may not deduct his travel expenses. That’s too general.

However, an anthropologist can deduct the cost of traveling to Egypt to study ruins as long as the research is part of her job.

Expenses to seek new employment
These expenses are deductible as long as you’re looking for a job in your current line of work. Otherwise, you don’t get a write-off.

New business location
You can’t deduct your travel costs for scouting new locations for your business, plant or branch. Nor can you write off travel expenses for seeking locations for a brand-new business or start-up. In both cases, these travel expenses must be capitalized and added to the cost of the new property. You can depreciate the property (other than land) later. Note, though, that the cost of an unsuccessful attempt to acquire a specific business generally is deductible.

Seeking foreign markets for existing products
If you travel abroad to seek foreign markets for existing products, you may deduct reasonable travel costs while you’re away from home.

But entertainment expenses are not part of the cost of traveling, even if you incur them while away from home. They must be handled according to regulations that govern entertainment expenses, as spelled out in the section beginning on page 10.
Meals and Lodging
While Traveling

You can deduct half the cost of your meals and all your lodging expenses only if you’re “away from home” in connection with your trade or business. “Home,” for tax purposes, is not always the place where you maintain your family residence.

Defining ‘home’ for travel purposes
For travel purposes, “home” is your place of business, your employment station or your post of duty, no matter where your family lives. That’s the rule issued by the IRS. The courts have upheld the rule, although the Tax Court occasionally has held that a particular taxpayer’s residence was his tax home.

Example: John Jones lives with his family in Chicago but works in Milwaukee. During the week he stays in a hotel in Milwaukee and eats his meals in restaurants, but he returns to his family in Chicago every weekend. Jones can’t deduct any of his expenses for traveling, meals or lodging because Milwaukee is his tax home and his travel is not for business reasons.

Two places of business
If you regularly work in two or more separate areas, your tax home is the general area where your principal employment or business is located. The principal place of employment or business is determined by the facts of each particular case. The most important factors are:

• The total time you ordinarily spend performing duties in each area.
• The degree of business activity in each area.
• The relative significance of the financial return from each area.

Costs of traveling to and from the minor place of employment, as well as meals and lodging at the minor post, are deductible, provided that the travel is away from home.

If you spend more time and earn more money at Location A than at Location B, Location A generally is considered your principal place of business—even if you live at Location B. If you spend more time at Location A but earn more money at Location B, there’s no clear-cut rule. The IRS is likely to accept either location as your principal place of business.

Example: Harriet Greene lives in Cincinnati, where she has a seasonal job for eight months of the year, and earns $20,000. She works the remaining four months in Miami at another seasonal job and earns $8,000. Cincinnati is Greene’s principal place of employment because that’s where she spends most of her time and earns most of her income.

If you have two or more regular work locations in the same general vicinity, the cost of commuting between the two sites is always deductible.

Example: Your main office is in Colorado Springs, Colo. You have a satellite office in Monument, Colo. (a nearby town). You can deduct all the costs of local travel between these two regular work locations. This is true even if you conduct two different types of businesses at the two locations. (IRS Revenue Ruling 55-109)

Salesperson’s ‘tax home’
A salesperson may live on the border of his working territory or may even live outside his working area. He uses his residence as a base, travels to the sales territory to visit customers and returns to his residence.

If that sounds like your arrangement, the IRS says you can deduct expenses for the trip from home to your first sales call of the day and from your last sales call back to home only if the home office is your principal place of business. (IRS Revenue Ruling 99-7) For outside salespeople, this was unlikely to be the case before 1997. The principal place of business was considered outside the home office because outside salespeople earn their income from visiting customer sites.

However, thanks to a 1997 law change, a home office now counts as your principal place of business if it’s used regularly and exclusively to conduct administrative or management
functions and you have no other fixed location that’s used for such activities.

As has always been the case under tax law, your office is also your principal place of business if that’s where you conduct most of your income-earning activities. The regular and exclusive use requirement applies in either scenario. Regardless of the status of your home office, you can always deduct the cost of traveling from one temporary business location to another during the day.

And even if your home doesn’t qualify as your principal place of business, you may still be able to claim deductions for the trips from home to your first temporary work location and from your last business location back home. (See the discussion of “commuting expenses” on page 7.)

**Temporary assignments**

Suppose you regularly work within the city or within the general area of your residence. But sometimes, you have to work or conduct business at another location, and it isn’t practical to return at the end of each day. If the work away from your regular post is strictly temporary, the location of your tax home doesn’t change; you’re considered to be away from home for the entire temporary period.

Work away from the regular post of duty is temporary if you can foresee its termination within a reasonably short time. An assignment that’s expected to last for a year or more isn’t considered temporary.

You can deduct necessary, round-trip travel expenses between your residence and your temporary assignment. You also can deduct reasonable expenses for meals and lodging while at your temporary location, even for days off.

**Indefinite assignments**

You might be assigned to work at (or you might shift your business to) a new location for an indefinite period of time; you don’t know when—or if—your new assignment will end.

In that case, the new location becomes your new tax home, and you can’t deduct expenses for travel, meals and lodging while you’re there. Also, the allowances for living expenses you receive from your employer must be treated as taxable income, even though they might be called travel allowances and you’re accountable for them.

Whether an assignment is temporary or indefinite must be determined at the time work begins. But a series of assignments to the same location, all of which are for short periods but which together cover a long period of time, might be considered an indefinite assignment.

**Example:** Ed Allen is an engineer who works for an Ohio firm and lives in Ohio with his family. He’s assigned to work at a big construction project in Florida for an indefinite period. While his family remains in Ohio, Allen works in Florida for two years. He returns to Ohio after the Florida job is finished.

The IRS says that Allen can’t deduct his Florida living expenses because he was on an indefinite assignment and his tax home switched to the Florida work site. Also, the expenses of his Ohio home are considered personal and not deductible (except for mortgage interest and property taxes).

**Requirement of overnight travel**

For tax purposes, you aren’t traveling away from home unless you stay away overnight.

The Supreme Court has upheld an IRS rule that a traveler can deduct meals and lodging on a business trip only if he or she is away at least overnight—or long enough to require rest or sleep. Otherwise, per diem allowances from the employer are treated as taxable income.

**Domestic travel for business and pleasure**

You might travel around the country and dabble in business and pleasure on the same trip. Round-trip travel expenses are deductible only if the trip is related primarily to your trade or business.

If the trip is primarily personal in nature, you don’t qualify for a write-off. However, your expenses at the destination that properly
relate to your trade are deductible even though the round-trip travel expenses aren’t.

Example: Eugene Grey works in Atlanta and is required to make a business trip to New Orleans. On his way back home, Grey stops over in Mobile, Ala., to visit his parents. He spends $990 for transportation, meals, lodging and other travel expenses for the nine days he’s away from home. If Grey had returned to Atlanta without the Mobile stopover, he would have been gone only six days and his trip would have cost only $850. Therefore, he may deduct only $850 as the cost of his trip to New Orleans.

Saturday night stay-over rule

Not satisfied with just partial write-offs when you mix business and pleasure?

Even the IRS agrees there’s a way to deduct all your expenses with no questions asked. The trick is to use a Saturday night stay-over to reduce the overall cost of the business trip. If you can show the air fare savings offset the costs of staying for the extra personal days, go ahead and deduct all your expenses. Of course, you must have a dominant business purpose for making the trip.

Example: You schedule a business meeting in San Francisco for Monday morning. You and your spouse fly in Friday night and spend the weekend on the town. On Monday you attend the meeting and return home that night. Assume your round-trip air fare (for you only, not your spouse) is only $600 versus $1,400 if you come in Sunday and leave Monday. As long as your expenses for the personal days (Friday and Saturday) are less than $800, you can justify writing off all your travel, meals (subject to the 50% rule) and lodging. You generally can’t deduct expenses for your spouse, such as air fare and meals and any extra charge for a double room, and there’s no write-off for the purely personal items such as play tickets and cab fares to tourist destinations.

In using the Saturday night stay-over scheme, make sure you nail down your deductions by carefully documenting the air fare savings and comparing them to the extra costs of staying the extra days.

Travel expenses for spouse or other family members

The travel, meal and lodging expenses your spouse or companion incurs when accompanying you on a business trip are deductible if your spouse works for your company and his or her presence serves a bona fide business purpose.

Incidental services, such as typing notes or entertaining customers, aren’t enough. The same goes for companions and other members of your family.

Example: The IRS relied on the business-purpose requirement to deny a write-off for convention expenses incurred by the wife of an insurance company executive. She accompanied her husband to the company’s annual convention. Invitations for these outings went to outstanding agents, managers and their spouses.

The wife contended that the company expected her to attend conventions. She accompanied her husband to all scheduled meetings and hosted any meetings at which he presided. But an unsympathetic IRS merely noted that she “is not in the business of selling insurance. Her presence did not serve a bona fide business purpose; the activities that she performed were ‘incidental.’” (IRS LR 7902008)

And more recent rules leave even less doubt. Because the spouse wasn’t an employee of the company, her expenses can’t be deducted, regardless of whether she served a legitimate business purpose.

If your spouse tags along on a business trip without a bona fide business purpose, the deductible business expense for transportation and lodging is the single-rate cost of similar accommodations.

Example: Susan McLaughlin drives to Chicago on business and takes along her husband, who doesn’t work for Susan’s company. McLaughlin pays $130 a day for a double room. A single room at the hotel would have cost $110. McLaughlin can deduct the total cost of driving her car to and from Chicago, but she’s
entitled to write off only $110 a day for her hotel room.

Of course, if your spouse or companion is an employee of another company, his or her employer can deduct the expenses if the trip has a business purpose for that firm. Also, if a spouse or companion is self-employed in his or her own business and has a business reason for making the trip, expenses can be written off.

For example, say you make a business trip to Eastern Europe on behalf of your company and your self-employed spouse makes the same trip with the legitimate purposes of visiting existing customers and drumming up new business. You both can write off your respective travel expenses in such situations.

**Foreign business trips**

If you travel abroad and devote all your time to business, your travel expenses are fully deductible. But you or your employer should make sure that a meeting on foreign soil is necessary, especially if you combine work and pleasure.

Otherwise, the IRS might disallow deductions for expenses incurred during conventions or similar meetings outside the “North American area.” While this rule sounds strict, it really isn’t because the IRS considers North America to include all the following spots: American Samoa, Antigua and Barbuda, Aruba, Bahamas, Baker Island, Barbados, Bermuda, Canada, Costa Rica, Dominica, Dominican Republic, Grenada, Guam, Guyana, Honduras, Jamaica, Marshall Islands, Mexico, Micronesia, Midway Islands, Netherlands Antilles, Northern Mariana Islands, Palau, Panama, Puerto Rico, Trinidad and Tobago, U.S. island possessions and the U.S. Virgin Islands. (IRS Revenue Ruling 2011-26) For all these locations, you have to show only that the convention had a legitimate business purpose and attending it was the primary reason for your travel.

To determine what’s reasonable, the IRS looks at:

- The purpose of the meeting and the activities taking place there.
- The purposes and activities of the sponsoring organizations or groups.
- The residences of the active members of the sponsoring organizations and the places at which these organizations or groups have held or will hold other meetings.

As a rule, the IRS doesn’t think it’s “reasonable” to hold your gatherings on a cruise ship. However, there’s an exception. An annual deduction of up to $2,000 is allowed for a business-related convention on a ship that’s registered in the United States and makes all its calls at ports located within the United States or its possessions.

**Foreign combined business/pleasure trips**

If you travel outside the country primarily for pleasure, you can’t deduct round-trip travel costs, but you can deduct business expenses at your destination.

If your trip outside the country is primarily for business but you played a little as well, you might have to allocate your costs between business and personal activities. However, no allocation is required if you meet any of these tests:

- You traveled for one week or less and you spent less than 25% of your time on personal activity.
- You’re not related to your employer and you aren’t a managing executive.
- You had no substantial control over arranging the travel.
- Personal vacation was not a major purpose of the trip.

**Limits on luxury water travel**

Business trips via ocean liners, cruise ships or other forms of “luxury water transportation” are subject to a per day deduction limitation. The per day deduction on the luxury boat can’t exceed two times the highest per diem amount paid by the federal government for normal business travel within the United States. The highest per diem rate for 2012 is $367 a day (for Vail, Colo.). For a city-by-city list of per diem rates,
see IRS Publication 1542 or go online to www.gsa.gov.

This limitation doesn’t apply to business travel for those who use luxury water transportation because of an illness or disability that restricts air travel.

Example: John Smith makes a business trip on a cruise ship, which takes six days each way. The applicable per diem amount is $367. For the 12-day round-trip voyage, the per diem limitation gives Smith a transportation deduction of no more than $8,808 ($734 per day for 12 days).

Generally, you can deduct only 50% of the cost of meals and entertainment on board the ship if these costs are itemized on your bill (see page 11). The 50% rule is applied before the per diem limit; however, the 50% rule does not apply if you don’t get a separate bill for the meals and entertainment.

The per diem rule doesn’t apply to expenses for business-related conventions and seminars held on cruise ships. In such cases, you may be able to rely on the rule that allows deductions for expenses of up to $2,000 (see page 6).

Train travel versus air travel

In a combined business-pleasure trip, days spent traveling to and from the business destination by a reasonably direct route count as business days. So if you have the time, travel by train or possibly by boat.

Cost of local travel

Transportation expenses for local travel conducted for business reasons include the fares charged for traveling by air, rail, bus, subway or taxi and the cost of operating and maintaining a car. But transportation expenses don’t include the cost of meals and lodging.

You can write off local transportation expenses that relate directly to the conduct of your trade or business, even if you’re not away from home.

Commuting expenses

Generally, expenses for commuting between your residence and a job in the same metropolitan area aren’t deductible. However, there’s an important exception if you work at temporary job locations. You can deduct the cost of commuting from your residence to the temporary sites in the following three circumstances:

1. You have an office in the home that’s your principal place of business—as explained earlier in the context of a salesperson. (See pages 3–4.)

2. You don’t have a home office that’s your principal place of business, but the temporary work site is outside the metropolitan area where you usually live and work.

3. You don’t have a home office that’s your principal place of business, but you have one or more regular work locations in the same trade or business. In this case, travel from your home to the temporary work site is deductible whether or not it’s outside your metropolitan area.

For purposes of these rules, a temporary work location is one where the assignment is expected to last less than one year. (IRS Revenue Ruling 99-7)

Examples: Your regular place of business is your employer’s office in Phoenix. For nine months, you travel from your home to a temporary job site where you are managing a major project for the company. Based on item 3 above, you can deduct the costs of commuting from your home to the temporary location, whether or not it’s in the Phoenix metropolitan area.

Based on item 1, ditto if you are self-employed with your principal place of business in your home office.

Now say you are self-employed but don’t have a home office that’s your principal place of business and you don’t have any other regular work location either. In this case, you can deduct the costs of commuting from your home to a temporary work site only if it’s outside your metropolitan area. (See item 2 above.) Of course, you can solve this problem by having a home office that qualifies as a principal place of business. Then item 1 would apply, and all your commuting costs to temporary sites (in the same metro area or otherwise) would be deductible.
Cost of Operating and Maintaining Business Vehicles

Deductible car expenses include the cost of gasoline, oil, lubrication, repairs, tires, supplies, garage rent, parking fees, tolls, chauffeur salaries and depreciation. These business expenses are deductible in addition to the itemized deductions for expenses such as interest on loans to purchase the car. Operation and maintenance costs are deductible to the extent you use the car for business.

You also can take depreciation deductions. If business use amounts to 50% or less, instead of the more generous accelerated-depreciation formula, you’ll have to use straight-line depreciation. In lieu of these deductions, you can determine deductible costs and depreciation by using the standard mileage rate.

Note: Other restrictions apply to depreciation deductions for so-called luxury cars. For 2011, luxury cars are considered those that cost $15,300 or more, resulting in a maximum first-year depreciation allowance of $11,060 for new (not used) vehicles put to business use in 2011 (or $11,260 for a light truck or van). For used vehicles, the maximum allowances for 2011 are $3,060 and $3,260, respectively.

Personal and business use of a car

If you use your car for both personal and business purposes, you must divide your expenses between business and personal travel unless your personal use is negligible. Total expenses (except parking fees and tolls) are deducted in proportion to business and personal use. Parking fees and tolls for business use are fully deductible. IRS Form 2106, Employee Business Expenses, includes schedules for the computation of automobile expenses and depreciation.

Recommendation: Determine whether the optional per mile rate or the total expense computation produces a larger deduction. Note: The optional method requires only proof of business miles traveled, while the regular method of computing actual expenses also might require receipts for those expenses if your return is audited.

Standard mileage rates

You can use the standard mileage rate in one year, compute your actual expenses and depreciation the next year and use the standard mileage rate again the following year. However, to switch to the cents-per-mile method for the same vehicle, you must have used the straight-line method to compute your depreciation. Parking fees and tolls during business use of the car are also deductible.

Note: The IRS periodically sets the standard mileage rate. The rate for 2011 was 51 cents per mile for the first half of the year, then 55.5 cents for the second half. For 2012, the IRS has adjusted the standard mileage rate to 55.5 cents per mile.

Use of standard mileage rates

You can claim the standard mileage deduction as long as you don’t use more than one passenger car at a time (including pickup trucks or vans) for business.

In addition, you must:

• Own the passenger car.
• Not use it for hire, such as for taxi service.
• Not operate a fleet of cars in which five or more are used for business simultaneously.
• Not have claimed depreciation on the car in a prior year using any method other than the straight-line method.
• Not have claimed additional first-year depreciation (under the “Section 179 rule”) with respect to that particular car.

Standard rate for alternating use of two cars

If you use more than one car, you can take the standard mileage rate deduction if both cars meet the requirements described above. The rate is applied to the total business miles racked up on both cars.

Example: John Rowe, a salesman, owns two cars. He uses one primarily for business; his wife drives the other car. But Rowe occasionally uses
the second car for business. If he drives the first car 12,000 business miles and the second car 4,000 business miles during 2012, Rowe may deduct $8,800 (16,000 miles at 55.5 cents per mile). Mileage rates may change (sometimes partway through the year), so check with the IRS for the latest figure.

**Mileage and reimbursements**

You can use the standard mileage rate deduction regardless of the amount of any car expense allowance or reimbursement you receive from your company or your employer, provided your income reflects the allowance or the reimbursement.

**Example:** Henry Brown, a salesman, drives his car 10,000 business miles in 2012. His employer gives him a weekly car expense allowance of $50. Brown may claim a “net” deduction of $2,950 (figure 10,000 miles multiplied by $0.555 equals $5,550 less $2,600 ($50 multiplied by 52 weeks)].

**Deductible nonbusiness car expenses**

If you itemize your deductions, you can write off certain car expenses even though the car is used entirely for personal purposes. You can deduct state and local personal property taxes (including that portion of the car license fee treated as a property tax) and certain casualty and theft losses. If you use the car for personal travel only part of the time, your itemized deductions can include only the amounts that you don’t claim as business travel or transportation expenses. (Fines for violation of traffic laws or other laws and regulations aren’t deductible.)

**Bigger deductions for ‘heavy’ SUVs**

If you choose to deduct actual expenses rather than use the standard mileage allowance, you should be aware of a potentially huge tax advantage for owning “heavy” SUVs, vans and pickups. As long as these vehicles have a manufacturer’s gross vehicle weight rating (GVWR) above 6,000 pounds, they’re considered “trucks” for tax purposes. **Tip:** The GVWR number can usually be found on a label located on the inside edge of the driver’s side door.

When these “heavy” vehicles are used more than 50% for business, they can be depreciated much more rapidly than other passenger vehicles.

In fact, you can probably deduct a large percentage of the cost of a heavy SUV used in your business in Year One, thanks to the Section 179 first-year depreciation allowance.

This valuable break allows you to deduct immediately up to $25,000 as long as the SUV is up and running by year-end. The SUV can be new or pre-owned. The tax results are the same for new and used vehicles (except in 2011 and 2012, when additional first-year bonus depreciation is allowed for new vehicles).

In fact, the tax law allows you to claim two first-year depreciation write-offs for your SUV: (1) a Section 179 deduction of up to $25,000 and (2) regular first-year depreciation on the depreciable cost left after the Section 179 deduction.

**Example:** In 2011, you buy a new heavy SUV for $45,000 to use 100% in your business. Thanks to the 100% first-year bonus depreciation break for new vehicles put to use in 2011, you can write off the full $45,000 on your 2011 federal income tax return. In contrast, the first-year depreciation write-off for a new $45,000 sedan used 100% for business would be only $11,060. That’s a big difference in favor of the heavy SUV.

Examples of popular SUVs with GVWRs above 6,000 pounds include the Chevy Tahoe, GMC Acadia, Ford Explorer 4WD, Toyota Sequoia and Mercedes M Class.

**Even better: Buying a heavy non-SUV**

A larger $500,000 Section 179 deduction for tax years beginning in 2011 is available for heavy business vehicles (those with GVWRs above 6,000 pounds) that aren’t considered SUVs under the tax law. Both new and used vehicles
can qualify for this important exception. Non-SUVs include:

- **Vehicles with a cargo area** of at least six feet in interior length that’s not easily accessible directly from the passenger compartment. For example, many pickups with full-sized beds will fit this description. Beware: Some “quad cab” and “extended cab” pickups may have cargo beds that are too short to qualify.

- **Vehicles designed to seat** more than nine passengers behind the driver’s seat. For example, many shuttle vans will fit this description.

- **Vehicles with** (1) a fully enclosed driver’s compartment and cargo area, (2) no seating behind the driver’s seat and (3) no body section protruding more than 30 inches ahead of the leading edge of the windshield. Many delivery vans will meet this description.

**Bottom line:** Heavy vehicles (both new and used) that fall under these three exceptions remain eligible for the full Section 179 instant write-off of $500,000 for tax year 2011. So you can probably write off the entire business percentage of the cost in Year One.

**Advisory 1:** The Section 179 deduction can’t exceed your aggregate business income before the deduction. This limitation prevents you from using the Section 179 break to generate an overall tax loss for the year. Years ago, when the Section 179 allowance was relatively modest, this wasn’t much of an issue. But the robust $500,000 allowance for non-SUVs makes it an issue. The good news: When you conduct your business as a self-employed person (sole proprietor, LLC member or partner), you can count wages—including your spouse’s if you file jointly—as business income for this purpose.

**Advisory 2:** The Section 179 allowance is phased out dollar-for-dollar to the extent otherwise qualifying assets costing more than $2 million (for tax years beginning in 2011) are placed in service during the year.

For example, say your business added $2.2 million of equipment during 2011. Your Section 179 allowance is cut back to $300,000 ($500,000 minus $200,000). While this limitation won’t affect many small businesses, you still need to be aware of it.

**Advisory 3:** If your Section 179 deduction is limited, a new (not used) heavy vehicle that is used over 50% for business and placed in service in 2011 or 2012 will still be eligible for first-year bonus depreciation. For eligible vehicles placed in service between 1/1/12 and 12/31/12, 50% first-year bonus depreciation is allowed. For eligible vehicles placed in service between 9/9/10 and 12/31/11, 100% first-year bonus depreciation is allowed.

### Entertainment

The 1993 tax reform act tightened the lid on deductions for business meals and entertainment. The deductible amount dropped from 80% of the tab to 50%. And meals aren’t deductible at all unless business is discussed before, during or after the meal, or the meal is directly related to or associated with the conduct of business.

The same general rules apply to other entertainment expenses. Also, the deduction allowed for the cost of sky boxes or other luxury sports event seats is limited to 50% of the retail cost of top-price tickets.

Also, beware of entertaining business associates or their families at locations the tax code describes as entertainment facilities. These include yachts, hunting lodges, fishing camps, swimming pools and tennis courts. Deductions for the cost of renting or owning such places will be thrown out.

Also on the disallowed list are expenses for renting or owning hotel suites, beach houses, ski lodges or any other housing located in recreational areas.

While the costs of renting or owning these types of entertainment facilities aren’t deductible, you can still deduct 50% of the cost of

providing business-related meals and entertainment activities at such facilities.

Dues and fees to social, athletic and country clubs are not deductible. However, the IRS has announced that it will permit deductions for dues paid to public service clubs such as the Elks, Kiwanis, Lions, Moose and Rotary. You also can take a full deduction for dues you pay to professional and civic organizations as long as your membership has a business purpose. The “approved” list includes business leagues, trade associations, chambers of commerce, boards of trade and real estate boards. To qualify for such a deduction, you must justify the cost as a business expense. Document the business contacts you make at these meetings and the income that you generate.

At all types of clubs, you can get a 50% deduction for out-of-pocket costs of business meals and entertainment as long you can substantiate a business purpose.

**Ordinary versus lavish entertainment expenses**

Entertainment expenses are deductible only if they are ordinary and necessary expenses of carrying on a trade or business or for the production or collection of income. Entertainment expenses aren’t deductible if they are deemed lavish or extravagant.

But the IRS won’t disallow your deductions merely because they exceed a fixed dollar amount or because you picked up the tab in deluxe restaurants, hotels, nightclubs or resorts. An expense will not be considered lavish or extravagant if, based on the facts and circumstances, it was reasonable at the time you incurred it.

**Entertaining at home**

Your costs for entertaining customers or clients at your home might be ordinary and necessary expenses. But you have to figure out how much it costs to feed yourself and your family at these affairs and then subtract that amount from your deduction. As always, be prepared to show a legitimate business purpose.

**The 50% rule**

The 50% deduction limit applies not only to business meals and entertainment. It also applies to taxes and tips, cover charges at nightclubs, party-room rentals, servers to help with parties and parking at theaters or sports events.

However, transportation to and from the business meal or entertainment is not subject to the 50% rule.

In general, the 50% limit is imposed after applying the limitations that disallow lavish and extravagant expense but before the application of the 2% floor for certain miscellaneous itemized deductions, including unreimbursed employee business expenses.

In other words, the IRS might trim your meal deduction if the tab was unreasonably high, then allow you to write off one-half of the remainder. Then you can deduct the amount that exceeds 2% of your adjusted gross income if you are an employee.

**Exceptions to 50% rule:** Expenses in the following categories are fully deductible:

- Amounts treated as taxable compensation. To qualify for this exception, the full value of the meals or entertainment must be treated as compensation to the recipients, whether or not they’re employees.
- Minor fringe benefits. These include expenses such as a subsidized cafeteria or de minimis fringes (for example, turkeys given out for holidays).
- Employer-provided recreation. This includes amounts paid for recreational, social or similar activities or employee events such as holiday parties, company picnics or office parties.
- Items made available to the public as samples or promotional material.
- Meals included as part of charitable sports events ticket packages.
Expenses for a sports event, to the extent they qualify as business expenses, may be fully deducted if: (1) the event’s primary purpose is to benefit a qualified charity; (2) all net proceeds go to the charity; and (3) the event uses volunteers to do nearly all the work.

The exception covers the entire cost of a ticket package, including parking and meals. The classic example is a charity golf tournament, even if the tournament offers prizes to participating golfers or uses paid concessionaires or security personnel.

**Note:** This favorable exception doesn’t cover tickets to high school or college football or basketball games or similar school events.

### Who can be entertained?

In general, you qualify for the deduction (subject to the 50% rule) only if you’re entertaining a “business associate”: that is, if he or she reasonably could be expected to engage in, or actively conduct, business with you. This includes clients, suppliers, partners, employees or agents—both established and prospective.

In addition, you can deduct one-half of the cost of entertaining your associate’s closely related companion. Who is a closely related companion? The best examples are a spouse or a colleague who has accompanied your associate from out of town.

IRS regulations aren’t very precise, but they do provide some examples of deductible entertainment situations:

- A new hotel or theatrical production may entertain business representatives and civic leaders.
- A hotel may entertain a good customer.
- A corporate president may entertain her vice president and sales manager.
- A manufacturer of products may entertain her retailers.
- A life insurance agent may entertain his clients.
- A dental equipment supplier may entertain dentists who are actual or prospective customers.
- A company may entertain a prospective employee.

**Note:** This list describes only whom you can entertain and still claim a deduction; it doesn’t describe the nature of the entertainment.

You can deduct 50% of meal and entertainment expenses only if you fall under one of the three following scenarios.

1. **Entertainment directly related to trade or business**

Entertainment expenses are deductible if they’re directly related to the active conduct of your trade or business. An entertainment expenditure meets the “directly related” test if you can show all the following:

- You had more than a general expectation of deriving income or other specific benefit (other than the good will of the person entertained).
- You discussed business with the person being entertained during the entertainment period. You will fail this part of the test if you try to claim you had business discussions in an atmosphere that’s not really conducive to quiet conversations, such as a nightclub, sporting event or theater. However, a restaurant is OK. So are other places that realistically allow you to conduct a business conversation without undue distractions. Think of this rule as basically requiring a table and chairs and not too much noise or commotion.
- The principal reason for the combined business and entertainment was the transaction of business or the expectation of future business.

You’re not required to show that business income or other business benefits actually resulted from every entertainment expenditure.

2. **Entertainment in a clear business setting**

You’re also entitled to deductions if you entertain in a “clear business setting” that furthers your trade or business. This includes:

• Entertainment that takes place in a “hospitality room” at a convention where you display your products or present your business services and where you have no meaningful personal or social relationships with the people being entertained.
• Entertainment that takes the form of price rebates in connection with the sale of your products. A simple example is a restaurant owner who occasionally gives free meals to regular customers.
• Entertainment designed to generate publicity rather than general good will, such as hotel owners or theater producers who entertain business and civic leaders at grand openings.

3. Entertainment associated with a trade or business

Some entertainment expenses don’t meet the “directly related” test or the “clear business setting” test, but they’re still “associated with” the active conduct of your trade or business. The costs are deductible if the entertainment directly precedes or follows a substantial and bona fide business discussion.

You pass the “associated with” test if you can demonstrate you had a clear business purpose when you incurred the expense, such as drumming up new business or maintaining a current business relationship. Keep in mind that you can write off one-half of the money you spend on people closely connected to you and your client, such as spouses, or maybe your attorneys. But the IRS won’t pick up the bar tab for an entourage.

Defining a business discussion

Whether a business discussion is “substantial” depends on the circumstances. You must show that you or your representative actively engaged in a discussion, meeting, negotiation or other bona fide business transaction (other than entertainment) for the purpose of generating income or some other specific business benefit.

The meeting doesn’t have to last for any specific length of time. However, you must document that the business discussion was substantial in relation to the entertainment. You don’t necessarily have to devote more time to business than to entertainment, nor do you necessarily have to discuss business during the entertainment period. As you can see, the guidelines are pretty murky, so check with your tax adviser.

Timing’s an important element if you want to meet the “associated with” standards described earlier. Obviously, entertainment that occurs on the same day as the business discussion is automatically considered as directly preceding or following it. But if the two events don’t occur on the same day, the IRS will assess the circumstances of each case.

Suppose a group of business associates comes to your firm for a business meeting. If you entertain your guests and their spouses on the evening before the meeting, or even a full day after the meeting, the entertainment generally is regarded as directly preceding or following the discussion.

Goodwill entertaining

The costs of wining and dining to maintain or create good will generally are deductible under these rules:

• “Associated with” entertainment rule, when the entertainment is associated with the active conduct of your trade or business and directly precedes or follows a substantial business discussion.
• “Clear business setting” entertainment rule, such as when the entertainment occurs in a hospitality room at a convention.

Example: Carl Crain, who is one of Sue Jones’ good customers, lives in a distant city. Crain contacts Jones when he is passing through Jones’ town, and Jones has a business discussion with Crain at Jones’ office. She then takes Crain out to dinner at an exclusive restaurant and to a nightclub (business is not discussed during the meal or at the club). Crain spends a lot of money with Jones’ firm during the year, and Jones is simply trying to retain Crain’s good will. Jones may deduct the ordinary and necessary expenses of the entertainment because it falls under the “associated with” entertainment rule.
Yachts, Vacation Resorts and Other Special Circumstances

No deductions are allowed for entertainment facilities. Generally, the term “facility” includes any item of real or personal property that you own, rent or use in conjunction or connection with an entertainment activity.

Such facilities include yachts, hunting lodges, fishing camps, swimming pools, tennis courts and bowling alleys. Entertainment facilities also might include airplanes and automobiles, or hotel suites, apartments and houses (such as beach cottages and ski lodges) located in recreational areas.

The entertainment facility restrictions don’t apply in the following situations:

✔ Business meal and entertainment deductions permitted under other regulations.

For example, if you take a customer hunting for a day at a commercial shooting preserve, the expenses of the hunt (such as hunting rights, dogs or a guide) are deductible as business entertainment provided you meet all the other requirements. These include substantiation, adequate records and the ability to show the expense was ordinary, necessary and “directly related” or “associated with” your business.

However, if you and your party stay overnight at a hunting lodge on the shooting preserve, the cost of the lodging is not deductible. But meal expenses are deductible if they satisfy the entertainment substantiation requirements. To be on the safe side, ask for receipts that are itemized according to deductible and non-deductible items.

✔ Payments for tickets to sporting and theatrical events, regardless of whether the tickets are purchased individually, in a series or by the season.

You also can deduct one-time fees to use seats, lounges, boxes or other similar facilities that provide special viewing areas. These costs generally are subject either to the rules for entertainment expenses or to rules for giving business gifts.

✔ Deductions for tickets, before applying the 50% rule, are limited to the face amount of the ticket.

Thus, amounts paid to scalpers or to ticket agencies in excess of the face value of the tickets aren’t deductible.

Exception: You can deduct 100% of the price of tickets to certain charitable sporting events that qualify as deductible entertainment, even if you paid a premium.

✔ Otherwise allowable expenditures for these items:
  • Facilities located on your business premises and used in connection with furnishing food.
  • Certain employee recreational facilities.
  • Facility expenses that are treated as taxable employee compensation.
  • Facilities made available to the public.
  • Facilities used in connection with your trade or business. In short, you’re in the clear if you’re in the business of selling entertainment—or selling entertainment facilities—for adequate and full consideration in bona fide transactions.
  • Interest, taxes and casualty losses.
  • The general rules for business meal deductions apply to the meals you buy in an entertainment facility as long as you meet all the tests.

Deductions for sky boxes

You can deduct half the cost of a sky box (including the cost of renting the box and charges for food, beverages and services) if you rent it for only one event. But season sky box rentals aren’t deductible (although you can write off one-half the cost of season tickets for regular seats, as explained below).

To qualify for a sky box write-off, you must meet the “directly related” or “associated with” standards for business entertainment described on pages 12 and 13, respectively. Your deduction is limited to one-half the face value of the most expensive regular seats in the stadium. The entire excess cost is disallowed.
All the seats in the sky box are included in the calculation of the disallowed excess cost for sky boxes rented for more than one event—even if you don’t use all the seats during a particular event. And if the stadium raises the price of certain seats that aren’t significantly better than the other high-priced seats, the inflated cost of the special seats is disregarded. These rules apply just to the sky box rental charges. The separately stated charges for food, beverages and services provided in the sky box are deductible under the general rules for business entertainment, subject to the 50% rule (see page 11).

Reduced deductions for personal use of company aircraft

Businesses can deduct only the amount reported as taxable compensation to “covered employees” for the use of company-provided aircraft.

For example, a company’s deduction for operating costs to fly a covered employee to her vacation destination on a company aircraft is limited to the amount reported to her as taxable compensation on her Form W-2.

In any case, the amount of the deduction can’t exceed the actual cost. But if the cost exceeds the amount reported as compensation, a business can deduct only the compensation amount.

Covered employees are defined as individuals subject to the requirements of Section 16(a) of the Securities and Exchange Act of 1934 or individuals who would be subject to such requirements if the employer were an issuer of equity securities referred to in Section 16(a). Those individuals generally include officers, directors and 10%-or-greater owners of private and publicly held companies.

Meals while on travel status

Basically, if you’re away from home overnight on business travel, you can deduct 50% of the cost of your meals. Traveling automatically qualifies meals as directly related to your trade or business—but only if you dine alone or with a business client or associate; otherwise, you can claim a deduction only for your own meal.

Example: Suppose you’re out of town on an important contract negotiation. A conflict prevents you from attending dinner with your clients and associates, but you pick up the tab anyway. In that case, you can’t claim a deduction, regardless of whether the other parties discuss business during the meal.

Observation: If neither you nor your representative attends the business meal, you can write off the cost of the meal as a business gift. However, the deduction is limited to $25 per recipient per year.

Business program lunches or dinners

To deduct the cost of meals that are part of a business program, or the price of banquets sponsored by business or professional associations, you don’t necessarily have to attend.

Example: A dental equipment supplier buys a table at a dental association banquet for dentists who are actual or prospective customers. The cost of the table qualifies for a 50% deduction.

Company-provided meals

The cost of food or beverages you furnish on your business premises primarily for your employees is fully deductible. Also deductible is the cost of maintaining the food and beverage facilities.

Legislation in 1998 opened up a new loophole in the area of company-provided meals. If your company qualifies, it can provide tax-free meals to employees—including the high-paid group of employee-owners and managers—and still deduct 100% of the cost even without operating a company eating facility.

The basic qualification rule is: More than 50% of your employees must receive this benefit for the convenience of the employer (your firm). If you pass that test, the on-premises meals—including those provided by a company cafeteria—are considered a de minimis fringe benefit for all employees who receive them.
De minimis fringe status means the employees owe no taxes on the value of the meals they receive, while the company still can fully deduct the cost.

Usually, workers will satisfy the convenience-of-the-employer test if they can’t leave the facility for meal breaks because of business reasons. IRS regulations list three sets of circumstances that satisfy the convenience-of-the-employer test:

1. **Meals are provided on premises** to make sure employees are available for emergency calls that might occur during the meal period. Emergency calls must actually occur or be reasonably expected to occur to qualify under this standard.

2. **The meal period is short** (45 minutes or less) because of the nature of the business. An example is a company with peak hours during the 11:30 a.m. to 1 p.m. time frame.

3. **Employees can’t otherwise obtain meals** during a reasonable meal period. For example, there are no eating facilities near the company offices, or heavy traffic prevents employees from leaving for meals and getting back within an hour.

The first circumstance listed above applies only to a few businesses, like ambulance companies. However, the other two could easily apply to your firm. If so, the company can fully deduct the cost, and none of the employees who receive meals (including the high-paid types) would be taxed on their value.

**Employee activities**

The expense of providing recreational, social or similar activities primarily for the benefit of your employees is fully deductible. You also can deduct the expense of using a facility for recreational, social or similar activities. However, officers, shareholders or other owners or highly compensated employees aren’t considered employees in determining whether the activity was primarily for the benefit of employees.

You’re considered a shareholder or other owner for this test only if you and your family own 10% or more of the business.

**Director, stockholder or employee meetings**

Most expenses directly related to business meetings of your firm’s employees, partners, shareholders, agents or directors are fully deductible—even if you provide some minor social activities. However, you still can deduct only 50% of the meal and entertainment expenses.

**Trade association meetings**

You can deduct expenses directly related to and necessary for business meetings or conventions of exempt organizations, such as business leagues, chambers of commerce, real estate boards, trade associations and professional associations.

**Expenses for spouses**

You might be able to deduct 50% of the cost of entertaining your spouse or the spouse of a business customer if you can show a clear business purpose rather than a personal or social purpose for incurring the expenses.

**Example:** You might entertain a business customer under circumstances where the cost is an ordinary and necessary business expense allowed under the “directly related” or the “associated with” entertainment rules.

The customer’s spouse joins the party for the entertainment because it’s impractical, under the circumstances, to entertain the customer without her husband. The cost of entertaining her husband is deductible as an ordinary and necessary business expense. If your spouse or companion joins the party because the customer’s spouse is present, the cost of entertaining your spouse also is deductible.

**Note:** Spouses and other dependents or companions generally must be employees of the company in order for their travel expenses to be deductible.

**Reciprocal entertaining**

Business acquaintances might take turns picking up entertainment checks at events that have no business purpose. Consequently, these expenses aren’t deductible.
Business Gifts as Deductible Expenses

The expenses for ordinary and necessary business gifts are allowed as deductions as long as they don’t exceed $25 per year to any single recipient.

A gift to the spouse or child of your client or customer is considered a gift to that individual. However, if your client’s wife has a bona fide business relationship with you, a gift to her will not be considered as made indirectly to her husband unless the gift is intended for his eventual use or benefit.

If you and your spouse give a gift, you’re both treated as one taxpayer for the $25 test even if you each have separate businesses relationships with the recipient. A partnership also is limited to $25.

When the $25 limit doesn’t apply

The $25 annual limitation on deductible business gifts to any individual doesn’t apply to the following items:

- Any item that costs $4 or less, has the giver’s name clearly and permanently imprinted and is one of a number of identical, widely distributed items. This covers items such as pens, desk sets and plastic bags.
- Signs, display tracks or other promotional material to be used on the recipient’s business premises.
- Employee awards of tangible personal property costing not more than $400 ($1,600 in certain cases).

Claiming and Proving T&E Deductions

The rules on who must prove and claim T&E deductions are spelled out in detail in this section. The checklist below provides a quick guide.

Expense allowances and reimbursements

Employee reimbursements and allowances for travel, transportation, entertainment, gifts and other ordinary and necessary business expenses in connection with your employment must be reported as income unless the following conditions are met:

- You’re required to make an accounting of your T&E expenses to your employer.
- The sum of the actual T&E expenses equals or exceeds allowances and reimbursements.

An employer may make a payment to one employee to cover the actual ordinary and necessary transportation and travel expenses to be incurred by several employees. The employees need not report their respective portions of the direct or indirect payments on their income tax returns provided that:

- The employee receiving the money properly submits to the employer the same detailed information required of each individual.

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• The sum of the payments equals the total actual business transportation and travel expenses.

Benefits of adequate accounting
Proper accounting can generate breaks for both the employer and the employee:
• No withholding is required.
• You don’t need to file a Form 1099 information return.
• The employee can use the optional standard mileage deduction.
• The burden of proving directly related and associated entertainment expenses shifts to the employer.

Logging expenditures
Make sure you keep an account book, a diary or a statement of expenses. Be specific. Log each element of an expenditure at or near the time the expenditure occurred. The statement of expenditures must be supported by documentary evidence.

You must account for all amounts you receive from your employer during the tax year as advances or reimbursements for travel, entertainment, gifts or any other purpose. You also must account for the amounts you charge to the employer directly or indirectly through credit cards or other means, such as company accounts.

Generally, you must submit to your employer the same type of records and supporting evidence you’d keep on hand to substantiate deductions on your own return.

Adequate accounting
for mileage allowance
Away from home: If your employer gives you the same mileage allowance that the IRS does (55.5 cents per mile in 2012), you don’t have to account for your actual expenses, but you do have to substantiate the time, place and business purpose of the business travel and the related mileage.

Local transportation: You don’t have to submit a written account of your actual expenses if you receive a local transportation allowance below the IRS-allowable limit, as long as the transportation is ordinary and necessary in connection with your employment.

Some employers use different reimbursement amounts for management than for non-management employees. In that case, the average reimbursement might qualify as a fixed allowance so that employees need not account for their mileage expenses.

In one case, management employees were reimbursed at 9 cents per mile, while other employees were reimbursed at 15 cents per mile for the first 100 miles each week and at 6 cents per mile for additional weekly mileage. The IRS accepted a yearly average figure of 9.6 cents per mile, and the employees weren’t required to account for their actual expenses.

Adequate per diem accounting
You might receive a fixed per diem allowance for meals, lodging and incidentals while traveling on business away from home. You meet the adequate accounting requirements if:
• Your employer limits payments to the per diem amounts that are allowed to federal employees.
• You substantiate the time, place and business purpose of the travel.

If these rules are followed, the employer can deduct the per diem amounts (subject to the 50% rule for amounts attributable to meals and incidentals). Also, the employee receives the per diem reimbursements as tax-free payments. In other words, if you follow the per diem rules, you’re considered to have made an adequate accounting of business travel expenses.

You have potentially three sets of per diem rules from which to choose (IRS Revenue Procedure 2011-47):

Per Diem Method 1: Under this method, you receive a location-specific allowance for meals and incidentals in each city you visit on business. (Incidentals are costs such as baggage and hotel tips and local transportation.) You still must turn in receipts to be reimbursed for your actual lodging costs. For example, the
2012 meals and incidentals allowance is $61 for Little Rock, Ark., and $71 for San Diego. Of course, only 50% of the Method 1 allowance is deductible. So the deductible amount would be $30.50 per day for Little Rock and $35.50 per day for San Diego. If you are self-employed, you can simply deduct 50% of the Method 1 amount and avoid having to keep track of actual meal and incidental expenses. You still must keep receipts to document and deduct your actual lodging expenses.

**Note:** For cities that aren’t specifically listed, the meals and incidentals allowance is $46 per day in 2012.

**Per Diem Method 2:** Under this method, you’re allowed to receive a larger combined allowance for meals and incidentals plus lodging. Then you don’t have to keep track of your actual expenses for any of these items.

For example, the combined 2012 allowance is $147 for Little Rock, Ark. ($61 of that is for meals and incidentals) and $204 for San Diego ($71 for meals and incidentals). Once again, only 50% of the amount for meals and incidentals is deductible. So the total deductible amount would be $116.50 per day ($147 – $30.50) in Little Rock and $168.50 per day ($204 – $35.50) in San Diego.

**Note:** For cities that are not specifically listed, the allowance is $123 per day in 2012, of which $46 is for meals and incidentals.

**Caution:** If you’re self-employed, you can use Method 1 but not Method 2. If you’re a corporate employee and also own more than 10% in value of the outstanding stock.

**Per Diem Method 3:** This is the so-called “high-low” per diem method. Under Method 3, every area in the country is classified as either a high-cost location or not. In high-cost zones, the 2012 allowance is a flat $242. Of that, $65 is deemed to be for meals and incidentals, and the rest for lodging. Everywhere else, the 2012 allowance is a flat $163 ($52 for meals and incidentals). Again, only 50% of the amount for meals and incidentals is deductible. So the deductible amount under Method 3 is $209.50 per day in high-cost areas ($242 – $32.50) and $137 per day in low-cost areas ($163 – $26).

**Caution:** Self-employed individuals and corporate employees who are more than 10% owners can’t use Method 3.

In summary, self-employed persons can use Method 1 but not the other two. More than 10% shareholder-employees can’t use any of the three per diem methods. They must record and turn in their actual business travel expenses. They can then receive tax-free reimbursements from the corporation.

**Observation:** The government’s per diem rates for travel in the United States are available at [www.gsa.gov/perdiem](http://www.gsa.gov/perdiem). The Method 3 high-cost areas for 2012 can be found in [IRS Notice 2011-81](http://www.irs.gov).

### Allowances for related employees

If you’re related to your employer, you can’t waive the accounting requirements under any circumstances, and you must substantiate any deductions you claim. You’re related to your employer if:

- The employer is a brother or sister (whether of whole or half-blood), husband or wife, ancestor or lineal descendant.
- The employer is a corporation in which you own (directly or indirectly) more than 10% in value of the outstanding stock.
- Trust grantors, fiduciaries and beneficiaries are in an employer-employee relationship.

### Employer controls for adequate accounting

Employers must exercise control over amounts paid out to ensure that only ordinary and necessary expenses are incurred.

One necessary control: The expense account must be examined and approved by an individual responsible, directly or indirectly, to the employer for a proper audit of the expense account. *The person incurring the expense* can’t approve his or her own account.
Ensuring unreimbursed outlay is necessary

When an employee incurs unreimbursed expenses, the employer should make it clear that the expenses are part of the job. A small corporation can do this by including an appropriate resolution in the corporate minutes. A larger corporation or an unincorporated business can achieve the same result with a written memo pointing out that employees are expected to pay for their expenses.

Example: Time Inc. helped its employees by issuing the following memo:

... Salespeople are paid high salaries because selling is not a routine job and makes demands on a person's time and money that cannot be accounted for minute by minute or penny by penny. There are many expenses incidental to selling that the salesperson is not expected to recover from the company on top of his salary. In a very true sense, a salesperson's job never ceases. And also, without exception, his business life is interwoven with his personal social life.

[We] make this point again because there are new people on the staff who may never before have heard it. And because it explains why the management does not expect an expense account to contain every phone call, every taxi ride, every luncheon and every drink bought by a salesperson in the course of his business and social existence.

Closely held corporations

The expenses of a corporation aren't the expenses of its stockholders. You can't incur expenses on behalf of your own corporation and deduct them on your personal return.

Instead, you should make an adequate accounting and be reimbursed. This allows your corporation to deduct the expenses while you receive the reimbursements tax free.
Section II: Backup Records to Support Your Deductions

Substantiation Rules for T&E and Listed Property

Substantiation is required for the following deductions: travel expenses while away from home (including meals and lodging), entertainment and arrangement of recreational activities or facilities and business gifts. For these items, you must substantiate:

- The amount of the expense or other item.
- The time and place of the travel, entertainment, amusement, recreation or use of the facility or the date and description of the business gift.
- The business purpose of the expense or other item.
- The business relationship to the taxpayer of the persons being entertained, using the facility or receiving the gift. (Internal Revenue Code, Section 274[d])

Note: While some form of substantiation (such as a monthly credit card statement or a notation in your daily planner) is always required for the amount of your meal and entertainment expenses, actual receipts are required only when the expense exceeds $75. The IRS always requires receipts for your lodging expenses, even for amounts less than $75.

In addition, you must meet substantiation requirements to claim deductions or credits for the business use of “listed” property. Listed property consists of items that readily can be adapted to personal use. Some examples:

- Any computer or peripheral equipment unless it’s used exclusively at a regular business establishment.
- Any passenger automobile.
- Any other property used for transportation, such as airplanes, trucks and boats.
- Property of any type generally used for entertainment, recreation or amusement (disc players, video recorders, etc.).

Under current law, you can back up your deductions with either adequate records or evidence to corroborate your own statements.

Observation: The more general substantiation requirements for ordinary and necessary business expenses (under Section 162 of the tax code) have been interpreted, in some instances, to permit uncorroborated statements to support business deductions.

No deduction is allowed for:

- Approximations or estimates.
- Expenses that are lavish or extravagant.

Caution: Deductions are most frequently disallowed because of failure to establish the place and business purpose of each T&E expense item claimed, and failure to establish the business relationship between the taxpayer and the person entertained.

Proving travel expenses

To write off travel expenses incurred away from home (including meals and lodging), you must document:

- The amount of each expenditure. The daily costs of incidental travel expenses can be grouped in reasonable categories, such as oil and gas, or taxi fares.
- Departure and return dates for each trip and the number of days spent on business activity.
- The destination or locality of the travel, described by the name of the city, town or other similar designation.
- The business reason for the travel or the nature of the business benefit you derived or expected to derive.
Proving entertainment expenses

Here’s what you must prove to support your entertainment deductions:

• A receipt for each separate expenditure in excess of $75 or some other form of documentation for lesser expenditures (such as a credit card statement or notation in your daily planner).

• The date the entertainment took place.

• Name (if any), address or location and type of entertainment, such as “dinner” or “theater,” if that information isn’t apparent from the name or designation of the place.

• The reason for entertaining, the nature of the business benefit you derived or expected to derive and the nature of any business discussion or activity that took place.

• The occupation or other information relative to the people you entertained, including name, title or other designation.

Proving business gift expenses

Here’s the backup information you need to deduct your business gifts:

• Description of the gift, your cost and the date you made the gift.

• The reason you made the gift, or the nature of the business benefit you derived or expected to derive.

• The occupation of, or other information about, the recipient, including name or title that firms up the business relationship.

Keeping a diary, account book or other record

Keep records of travel, entertainment and business gift expenses in an account book, a diary or a statement of expenditures. Your entries should be supported by documentary evidence.

You’re not required to record travel allowances you receive from your employer. But you must record the cost of items you charge to your employer on credit cards or company accounts.

A written statement of the business purpose of an expenditure is generally required. But the degree of substantiation of business purposes varies according to the facts and circumstances of each case. Sometimes the business purpose is obvious, so it doesn’t require a written explanation.

Timely records

Be sure to record the expense at or near the time the expenditure is made. That way, you’ll get the maximum deduction. Too many business travelers make the entries after they return home, when memories are fuzzy.

That’s how Carol Burke learned an expensive lesson. Burke was an airline flight engineer. She also served in the U.S. Navy Reserve. Both positions required her to travel. Burke claimed deductions for unreimbursed expenses, which she noted in a diary. However, the Tax Court ruled that the diary didn’t substantiate certain disputed outlays.

“In certain instances,” the court said, “the place and business purpose of her travel were recorded in later years.” Burke managed to salvage some of her write-offs through her own testimony, backed up by flight logs and other supporting documents. (Burke, TC Memo 1979-195)

When documentary evidence is required

Documentary evidence is a receipt, a paid bill or similar evidence sufficient to support an expenditure. Receipts are required to support all expenditures for lodging while away from home and for any meal and entertainment expenses of $75 or more. Transportation charges are exempt if documentation isn’t readily available.

Because no supporting evidence is required for travel and entertainment expenses of less than $75 (except lodging), an up-to-date diary of these expenses can’t be challenged, except for fraud. Having said that, don’t tempt a fraud charge by, for example, claiming a $74 write-off for each and every business meal when it’s obviously unreasonable to think you would regularly spend such a large amount. However,
even a proper diary entry won’t support any part of an expense of $75 or more if you don’t have a companion receipt.

Documentary evidence ordinarily is considered adequate if it discloses the amount, date, place and essential character of the expense.

For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the name and location of the hotel, the date or dates of your stay, and separate amounts for charges such as lodging, meals and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the name and location of the restaurant, the date and amount of the expenditure and an indication that a charge (if any) was made for an item other than food and beverages.

Confidential information

If the information regarding your business purpose or your business relationships is confidential, you don’t have to log it in your account book. Just make sure you record it somewhere else at or near the time of the expenditure. But it must be available to the IRS district director to substantiate the confidential element of the expenditure.

Entertaining large and small groups

When you entertain a large group, you don’t have to record every name if you can readily identify the group some other way—say, by profession.

If you entertained all the stockholders of a small corporation, for example, a designation such as “all the stockholders of the Acme Corp.” is sufficient. But if the designation is too broad, such as “customers of Ajax Corp.,” the IRS won’t buy it. Instead, you might try “Jones, branch manager of Acme Corp., and his 15 salespeople.”

Employer’s records and supporting documents

If you’re an employer, you must keep the records and supporting documents submitted by your employees if you intend to deduct their allowances and reimbursements.

Form of records

The records may be in any form, but they must be sufficient to substantiate the expenditures. The chart on page 24 illustrates the standards of proof.

If you deduct your T&E expenses, you must be able to substantiate the elements listed in column 1 of the chart by proving the factors listed in columns 2, 3 and 4.

For example, if you deduct an entertainment expense as “directly related” to your trade or business, you can ignore the factors in parentheses. If you claim the deduction under any other standard, you must consider all the factors we’ve listed in the chart (depending, of course, on the type of deduction you claim).

Establishing amount of expenditure

A receipt is the best evidence to prove an expenditure of more than $75. If you don’t have the proper receipts, you can rely on other documentary evidence, as long as it’s very specific. For example, you might document your meal expenses with a written statement signed by your dinner partners or, better yet, your waiter.

If you lose your receipts because of flood, fire or other casualty, a reasonable reconstruction of your expenses will suffice.

Retention of records and receipts

You must retain proof to support your deductions as long as your income tax return is open for audit—generally, at least three years.

If you submit your records to your employer to get reimbursed, you don’t have to keep duplicates. But you might be required to substantiate your costs independently if you claim deductions for expenses that exceed reimbursements, if you are a related stockholder-employee or if your employer’s accounting procedures aren’t up to snuff. What’s more, the IRS reserves the right to require additional information to clarify your evidence or to establish the accuracy of the records you supply.
## Factors You Must Prove to Substantiate Expenditures

<table>
<thead>
<tr>
<th>Elements to substantiate</th>
<th>For expenditures for travel away from home</th>
<th>For expenditures for entertainment</th>
<th>For gift expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Amount</td>
<td>Amount of each separate expenditure for transportation, lodging and meals. Permissible to aggregate incidental expenses in reasonable categories, such as gasoline and oil, taxis, daily meals.</td>
<td>Amount of each separate expenditure. Incidental items, such as taxis and telephones, may be aggregated on a daily basis.</td>
<td>Cost of business gift to taxpayer.</td>
</tr>
<tr>
<td>(2) Time</td>
<td>Dates of departure and return for each trip and number of days attributable to business activities.</td>
<td>Date of entertainment or use of a qualifying facility with respect to entertainment. (Duration of business discussion.)</td>
<td>Date of gift.</td>
</tr>
<tr>
<td>(3) Place</td>
<td>Destination by name of city or some other appropriate designation.</td>
<td>Name and address or similar designation of place of entertainment, or place or use of a qualifying facility in connection with entertainment. Type of entertainment if not apparent. (Place of business discussion.)</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>(4) Description</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
<td>Gift description.</td>
</tr>
<tr>
<td>(5) Business purpose</td>
<td>Business reason for travel or nature of business benefit derived or expected to be derived.</td>
<td>Business reason or nature of business benefit derived or expected to be derived. Nature of business discussion or activity if entertainment is other than business meal.</td>
<td>Business reason for making the gift or nature of business benefit derived or expected to be derived.</td>
</tr>
<tr>
<td>(6) Business relationship</td>
<td>Not applicable.</td>
<td>Occupations of or other information about persons entertained, such as names or other designations, which establishes their relationship to taxpayer. (Identification of persons who participated in business discussion.)</td>
<td>Occupation of or other information about recipient, such as name or other designation, which establishes business relationship to taxpayer.</td>
</tr>
</tbody>
</table>
Recordkeeping rules for local transportation expenses

Expenses for local transportation are subject to more liberal recordkeeping rules than those that apply to entertainment, business gifts and travel away from home.

In other words, you’re liable to get away with a deduction for local transportation costs, even if you can’t substantiate them.

You need not keep detailed records for tips, cab fares and incidentals. A reasonable estimate is enough. However, you will need good records for local transportation costs related to your entertainment expenses.

Disallowance of Deductions

Everything we’ve told you so far should keep you on the tax collector’s good side. Some of the rules are complicated so you might need an accountant’s help. But the effort will pay off. Take a look at the consequences of shoddy recordkeeping.

How disallowed T&E expenses cause trouble

As you know, when the IRS disallows deductions for your reimbursed expenses, your taxes go up because the reimbursements become taxable income. But with a closely held C corporation, a disallowed deduction might result in a double tax to the C corporation employer and the shareholder-employee. In other words, the employer’s deduction is wiped out, and the amount is tacked on to the employee’s income as a taxable dividend.

Civil and criminal tax penalties

If T&E amounts are used for a stockholder-employee’s personal expenses, the government can add the 75% civil fraud penalty to the double tax. Diverting T&E funds also can result in criminal penalties. In one case, the president of a corporation was convicted of evading both corporate and personal income tax when he used the amount he claimed as T&E expenses to finance a Caribbean vacation.

Conclusion

Exposure to IRS penalties (or worse) points out the importance of: (1) limiting your expense account deductions to what the tax law allows and (2) making sure you have the documentation needed to support your legitimate deductions.

If you follow the advice in this special report, you’ll be in good shape on both counts.

Remember, if you’re ever audited, travel and entertainment deductions and reimbursements to owners and key employees will be among the first factors to come under scrutiny. So spending some extra time doing things right is definitely in your best interest.
Savvy small businesses take a proactive approach to seizing all the business tax credits and deductions they’re legally entitled to under current tax law. Don’t add to your tax bill by overlooking crucial write-offs or stumbling over IRS penalties.

You can access informative articles on how to reduce (or AVOID) business and personal taxes when you log on to Business Management Daily (www.BusinessManagementDaily.com), the comprehensive business web site from the publishers of 76 Ways to Maximize Expense Account Deductions.

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