

RSM! McGladrey

Travel, Entertainment and Potential Personal Use Property

Introduction.

A predominant theme running through tax law is the encouragement of business activity. Ordinary and necessary business expenses are generally tax deductible, while expenses incurred for personal reasons or pleasure are not. This distinction is particularly difficult to make in the area of travel, entertainment and business gift expenses because these expenses have both personal and business components.

Out of concern that taxpayers may attempt to deduct otherwise personal expenses, tax laws were enacted to subject these types of business and investment expenses to special limitations and requirements for deductibility. In the area of documentation, specified records must be kept to support a business deduction. Furthermore, certain types of expenditures may be limited or disallowed. For example, business meals and entertainment are only 50 percent deductible; however, exceptions apply which may allow 100 percent deductibility. Claiming these deductions without regard to limitations or proper documentation retention can result in substantial tax, penalties and interest when the deductions are disallowed. Alternatively, failure to utilize certain tax-planning techniques can result in missed deductions and overpaid taxes.

Why should you care so much about these rules? Although IRS examinations vary from taxpayer to taxpayer, one thing inevitably remains constant: the IRS examiner will likely review your travel and entertainment

expenses and related documentation. The IRS is quick to investigate these expenses because more often than not taxpayer abuse and failure to keep required records leads to immediate audit adjustments. Your understanding of what documentation is required will help ensure that an otherwise deductible business expense does not get disallowed!

This booklet explains in general terms the expenses that need to be documented and what detail should be included in your records. It also describes other special rules and requirements for deductions of travel and entertainment, business gifts, and listed property expenses. Although many tax publications focus on what you can't do, our focus is on what you can do to prevent unnecessary audit adjustments and find hidden opportunities. Please consult your tax advisor for further explanation of how these rules apply to your unique situation.

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Meal and Entertainment Expenses.

It should be noted that, unless otherwise stated, any reference to "meals" in this section is in the context of entertainment as opposed to meals incurred while in a travel status.

In order to qualify as a deduction, most meal and entertainment expenditures must meet three requirements:

1. You must be able to prove or substantiate the claimed deduction by maintaining adequate records. Record-keeping requirements are discussed at the end of this publication.
2. The expenditure must be an ordinary and necessary trade or business expense. Amounts expended for meals may not exceed an amount that may be considered lavish or extravagant.
3. Based on the purpose of the expense incurred, the expense must meet certain eligibility requirements as noted below.

Directly connected/associated meals and entertainment.

To be deductible, the meal and entertainment expenditure must either be:

1. *Directly connected with the taxpayer's trade or business.* Directly connected entertainment involves entertaining customers and other business-related individuals as an integral part of making a sale or accomplishing a business transaction. An example would be a meal in which a business discussion or negotiation takes place. The taxpayer (or the taxpayer's employee) must be present to deduct the related expenses.
2. *Associated with the taxpayer's trade or business.* Associated entertainment involves entertaining customers or other business-related individuals directly preceding or directly following significant business activity. This provision allows for an entertainment

deduction when the entertainment activity itself is carried on in a setting that does not lend itself to a business discussion (e.g. a nightclub or a sporting event).

The entertainment deduction is allowed **only** if the taxpayer adequately documents that a business meeting, negotiation or bona fide business transaction took place directly before or after the entertainment. A variety of expenditures may be made under this category, including tickets to events such as shows or sporting events, green fees, travel to a resort, cost of accommodations, direct costs of operating a boat, etc. If the entertainment and business discussions are not held on the same day as the entertainment you must consider the facts and circumstances of each case to determine if the "directly connected to" and "associated with" tests are met. The taxpayer (or the taxpayer's employee) must be present during the business meeting, negotiation or transaction.

Tip: Entertainment expenses allocable to the spouse of either the taxpayer, the taxpayer's employee or of the taxpayer's business customer may also be deductible provided a business discussion took place between the taxpayer and the business customer under either the directly connected or associated rules described above.

The following meal and entertainment expenses are not subject to the rules discussed above requiring a substantive business discussion before, during or after the meal or entertainment.

Caution: Certain exceptions noted below are subject to other rules and restrictions outside the scope of this publication. You should consult your tax advisor concerning these exceptions:

- Food and beverages furnished primarily for employees on the business premises.
- Meal and entertainment expenses included as compensation on the employee's W-2. The employee, not the employer, would be subject to the above deductibility requirements.
- Meal and entertainment expenses paid or incurred in connection with the performance of services for another taxpayer under a reimbursement or other expense allowance arrangement (described later). This exception applies to both employees seeking reimbursement from employers and independent contractors seeking reimbursement from clients. Note that only the taxpayer making reimbursement is subject to the deductibility requirements.
- Recreational or social expenses for employees (including facilities) if the expenses are primarily for non-highly compensated employees. Examples include holiday parties, annual picnics and maintenance of facilities used by employees such as swimming pools, athletic fields, etc.
- Expenses of business meetings of employees, stockholders, directors, etc.
- Expenses of attending meetings of nontaxable organizations, such as chambers of commerce, business leagues, real estate boards and certain professional associations.
- Expenses of entertaining the general public, such as the opening of a new store.
- Meals and entertainment sold to customers.

- Meal and entertainment expenses treated as non-employee compensation or prizes that are includable in the income of the recipient.

Goodwill entertaining.

Goodwill entertaining involves entertaining customers, potential customers, bankers, attorneys, etc., simply to gain their goodwill. These meal costs are not deductible unless a substantial business discussion took place immediately before, during or after the meal. The topic of the discussion should be documented.

Example: Mr. Charity, vice president of the Hospitality Corporation, takes the company's banker and spouse out for drinks, dinner and the opera. He has no business meetings with the banker before or after the meal and entertainment and does not have any serious business discussion with him during the evening. Neither the cost of the food and beverage, nor the cost of the opera is deductible, regardless of whether Mr. Charity or Hospitality Corporation pays for the evening. Furthermore, if Mr. Charity were a shareholder in Hospitality Corporation, and Hospitality Corporation paid these entertainment expenses, the IRS might construe this expenditure to be a preferential dividend paid by Hospitality Corporation to Mr. Charity.

Club dues.

The Revenue Reconciliation Act of 1993 repealed all deductions for club dues representing memberships in any business, pleasure, recreation or social club. The rule applies to all types of clubs including country clubs, luncheon clubs, airline clubs and hotel clubs.

Tip: Although club dues may be nondeductible, out-of-pocket expenditures such as food, beverages, catering, etc., while

consumed within a club setting, remain deductible within the general rules and limitations outlined in this publication. Many employers still require certain employees to be members of business, social or recreation clubs. If an employer pays nondeductible club dues for an employee the employer has two options with respect to the tax treatment:

1. Employers may deduct payments for 100 percent of an employee's club dues as compensation if the employer adds the full cost of dues to the employee's W-2.
2. If the employee substantiates the business-use portion of the club dues the employer may choose not to claim a deduction for the business portion. Likewise, the business-use portion may be excluded from the employee's W-2 as a working-condition fringe benefit. The employer must, however, include the personal-use portion of club dues on the employee's W-2. The employer is entitled to a compensation deduction for the personal-use portion included on the employee's W-2.

Many factors unique to your particular situation should be considered before choosing one of these options. Your tax advisor can help you determine which option is best for you.

Tip: The 1993 Act does not apply to certain dues paid to business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations (e.g., bar associations and medical associations), and civic or public service organizations (e.g., Kiwanis, Lions, Rotary and Optimist clubs and similar organizations). However, any dues paid to these organizations must qualify as an otherwise ordinary and necessary trade or business expense.

Entertainment facilities.

Because of the personal nature inherent

within the ownership or use of an entertainment facility, our tax law has developed a complex web of restrictions to discourage their use and limit their deductibility. Expenditures associated with the fixed costs of owning or leasing an entertainment *facility* are not deductible. On the other hand, expenditures associated with the direct cost of entertainment *activities* remain deductible, provided they meet other deductibility requirements of the law.

Tax law draws a confusing line between the definition of what it considers to be an entertainment *facility* and an entertainment *activity*. A general rule of thumb is the concept of *exclusivity*. If a taxpayer leases an entire area to be used by him and his clients exclusively for fishing, the area becomes an entertainment *facility* and the lease cost is not deductible. If, on the other hand, the taxpayer pays admission for himself and his clients to share a public area for fishing purposes, the expenditure becomes an entertainment *activity* and may be deductible assuming it meets all other deductibility requirements.

Entertainment facilities include ownership or rental of boats, cabins, motor homes, condominiums, hotel suites (as opposed to an ordinary hotel room), etc. Thus, the fixed costs of depreciation, maintenance, utilities or rental expenses attributable to the ownership or use of such items are not deductible. The deduction disallowance applies to the entire facility throughout the year even though the facility may, at other times, be used for business purposes other than entertainment.

The transportation use of an airplane, yacht or automobile is also deemed to be a facility when used in connection with entertainment. Thus, the fixed costs attributable to the ownership or use of such items are not deductible.

Tip: A narrow exception in the law for business use of transportation vehicles does allow a deduction of fixed costs attributable to business use not connected with entertainment. Accordingly, use of a corporate-owned jet to transport a client to a resort for entertainment purposes will limit only the fixed costs of the jet used for that specific trip. The portion of the fixed costs of operating the jet for business-related activities not associated with entertainment remains deductible if otherwise allowable under other provisions of the law.

Tip: Out-of-pocket costs incurred solely because of an actual business entertainment use of a facility, such as gasoline, food, consumable supplies etc., are deductible within the general limits for entertainment expenses. Taxes and casualty losses are deductible without regard to business use of the facility.

Example: The president of Collins Sporting Goods, Inc. takes the president and vice president of a major vendor on a hunting trip in hopes of closing a major business transaction. The three individuals will travel via Collins' corporate-owned jet, hunt at a private reserve and stay the night in an exclusive hunting lodge before returning home the following day. The fixed costs associated with the airplane, admission to the hunting reserve and lodge rental are nondeductible as entertainment facility costs. Meals consumed and airplane fuel costs remain deductible.

Tip: If, in the above example, the president of Collins Sporting Goods had transported his clients to a public hunting reserve via a commercial airline and stayed the night in a hotel, the entire cost of the trip may have been deductible.

Some limited exceptions to the above rules do allow for deductions with respect to certain entertainment facilities. Examples include recreational facilities used by

employees, facility expenses treated as compensation, taxpayers in the trade or business of selling either entertainment or facilities to which the entertainment relates, and facilities made available to the general public.

Corporate ownership of an entertainment facility may create negative tax consequences for owners and employees alike. Likewise, erroneous deductions associated with the use of a facility can lead to substantial assessments of tax, penalties and interest. You should consult with your tax advisor before considering the use or ownership of an entertainment-type facility.

Meal and entertainment percentage disallowance rule.

The deduction for otherwise allowable meal and entertainment expenses must be reduced by 50 percent of the actual expense. This limitation is often misunderstood to apply only to meals; however, the limitation also applies to **all** entertainment expenditures such as sporting events, theater tickets, green fees, etc.

Note: Meals subject to the 50 percent disallowance rule include those consumed during travel or other business activities not associated with entertainment.

A few exceptions to the disallowance rule enable taxpayers to deduct the full cost of meals and entertainment expenses. Note this is not the same list previously shown as exceptions to the "directly related/associated with" rule. The exceptions are:

- Meal and entertainment expenses included as compensation on the employee's W-2. The employee, not the employer, would be subject to the 50 percent disallowance rule. Other limitations imposed on an individual's itemized deductions are likely to further limit the employee's deduction.

- Expenses for food or beverages that are excludable from the gross income of an employee as a de minimis fringe benefit. Examples include meals provided to employees while on the employer's business premises for the convenience of the employer, eating facilities operated by an employer for the benefit of employees provided certain conditions are met, and occasional supper money given to an employee who is required to work overtime.
- Meal and entertainment expenses paid or incurred in connection with the performance of services for another taxpayer under a reimbursement or other expense allowance arrangement (described later). This exception applies to both employees seeking reimbursement from employers and independent contractors seeking reimbursement from clients. Note that only the taxpayer making reimbursement is subject to the 50 percent disallowance rule.
- Recreational or social expenses for employees (including facilities) if the expenses are primarily for non-highly compensated employees. Examples include holiday parties, annual picnics and maintenance of facilities used by employees such as swimming pools, athletic fields, etc.
- Expenses of entertaining the general public, such as the opening of a new store.
- Meals and entertainment sold to customers.
- Meal and entertainment expenses treated as non-employee compensation or prizes that are includable in the income of the recipient.

- Entertainment expenses incurred at certain charitable fund-raising sports events provided that certain conditions are met.
- Meals included in reimbursed employee moving expenses that are included in the employee's taxable income.
- Food or beverages provided to crewmembers of certain commercial vessels and oil and gas platforms.

Consult with your tax advisor to make certain that you are taking full advantage of any exceptions to the 50 percent disallowance rule.

Other deduction limitations.

The deduction for event tickets used for business entertaining is limited to the face value of the ticket irrespective of any premium paid. The lavish and extravagant element of the ticket cost in excess of its face value must be subtracted before the percentage disallowance rule (discussed above) is applied.

Special rules apply to skyboxes or private luxury suites at sports stadiums that are leased for more than one event. In such situations, the deduction is limited to the amount charged for non-luxury box seats.

Business Gifts.

In order to qualify as a deduction, you must be able to prove or substantiate the claimed deduction by maintaining adequate records. Record-keeping requirements are discussed at the end of this publication.

Limitations on deduction.

A maximum of \$25 is deductible for gifts to any one customer or other business-related individual in any one year. A gift to the spouse of such person is treated as a gift to the person, unless the spouse is also a customer or business-related individual.

Example: Mrs. Books, an accountant, calls a client and says she will send over two tickets to the football game. The tickets cost \$40. A deduction is allowed for \$25. Two weeks later she sends a radio to the client's wife who is not a customer. The cost of the radio is not deductible since only one gift per customer per year is allowed, and Mr. and Mrs. Client are considered one person for purposes of the \$25 limitation.

An item costing no more than \$4.00 on which the name of the taxpayer is imprinted is not subject to the gift limitation rule discussed above, provided identical items are distributed by the taxpayer. Incidental costs, such as engraving and wrapping, are not included in the \$25 annual limitation. A cost is considered incidental only if it does not substantially increase the value of the gift.

Business Travel Expenses.

To qualify for a deduction, business travel expenses must meet three requirements:

1. You must be able to prove or substantiate the claimed deduction by maintaining adequate records. Record-keeping requirements are discussed at the end of this publication.
2. The deduction must be an ordinary and necessary trade or business expense not exceeding an amount that may be considered lavish or extravagant.
3. Based on the purpose of the expense incurred, the expense must meet certain eligibility requirements as noted below.

Local transportation.

The costs of commuting (i.e. going to and from home and place of work) are personal in nature and are not deductible even if work is performed during the commute, such as by cellular telephone or discussions with fellow commuters.

Once you reach your regular or main job location, all subsequent business-related transportation expenses from that location (e.g., visiting customers, going to the bank, visiting a job site, etc.) are generally deductible. Transportation-related deductions include the business-use portion of the costs of operating an automobile, public transportation, parking and tolls.

In lieu of keeping track of the actual costs of operating an automobile, a deduction may be calculated at a rate per business mile as set by the Internal Revenue Service (standard mileage rate). The standard mileage rate applies to both local business travel and travel away from home and is used in place of the operating and fixed costs of the automobile allocable to business use. Operating and fixed costs include depreciation, lease payments, maintenance

and repairs, tires, gasoline, oil, insurance, personal property taxes and registration fees. Refer to the Appendix for the current standard mileage rate.

Tip: If the cost (i.e. purchase price) of an automobile used for business purposes is high, the standard mileage may result in smaller deductions than those supported by detailed record keeping. Alternatively, use of the standard mileage rate with respect to a low-cost automobile may result in a deduction higher than the actual operating costs. Your tax advisor can help you determine which method will result in the overall greater deduction.

Tip: The business-use portion of parking fees, tolls, interest, and state and local taxes may be deducted in addition to the standard mileage rate.

Tip: Interest paid by an employee on a car loan is nondeductible personal interest even though the car may be used for business purposes in the course of his or her employment. However, a self-employed taxpayer may claim the interest paid on the business portion of a car as a business expense. The remaining non-business portion is personal interest

The standard mileage rate is disallowed under each of the following conditions: (1) if the automobile was previously depreciated using an accelerated depreciation method, (2) if the automobile is used for hire, such as a taxicab, or (3) two or more automobiles are used simultaneously, such as in fleet operations. In 2004, the standard mileage rate will be allowable on up to four autos that are used simultaneously.

Note: Expenses incurred for meals and lodging with respect to local travel are **not** deductible. The term "local" refers to travel within the area of the taxpayer's home.

Travel away from home – domestic.

In order to be deductible, meals, lodging and other business-related travel expenses must be incurred while in a temporary travel status away from your "tax home" for such a duration as to require sufficient time to obtain substantial sleep or rest before returning home.

The term "tax home," as referred to in the sentence above, generally refers to the taxpayer's personal residence located near his or her principal place of business. If, for personal reasons, a taxpayer chooses to live a significant distance from his principal place of business, the taxpayer's principal place of business becomes his tax home for purposes of applying these rules.

Example: Mr. Liveaway works four days a week in his Dallas office and one day a week in his company's branch office in Phoenix. Mr. Liveaway maintains a home for himself and his family in Phoenix and an efficiency apartment in Dallas. For tax purposes, Mr. Liveaway's tax home is Dallas, where he earns more of his income and spends the greater amount of time. Therefore, Mr. Liveaway's travel and lodging expenses with respect to his time spent in Dallas are not deductible because he is not away from his tax home.

Tip: You may deduct travel expenses between your principal place of business (i.e. tax home) and a temporary or minor post of duty. Travel expenses may be claimed even though your family lives at the temporary or minor post of duty. In such cases, however, the deduction is limited to that portion of the family expenses for meals and lodging which is properly attributable to your presence there in the actual performance of your duties.

Example: Because Mr. Liveaway in the above example works one day a week in Phoenix he may be entitled to deduct that

portion of his family meal and lodging expenses associated with time he actually spends in the performance of his business duties.

Tip: If the primary purpose of an out-of-town trip is business, all transportation costs to and from the business destination, together with meals and lodging for the business portion of the trip, are deductible, even if you spend part of the time vacationing. On the other hand, if the trip is primarily for pleasure, no part of the transportation costs is deductible, even though a part of the trip may involve some business activity. However, any expenses incurred while at your location that are "directly related to" or "associated with" your trade or business would be deductible subject to the general meals and entertainment limitation rules.

Example: Mr. Writeoff travels to Chicago and spends four days on business. He takes the opportunity while there to spend three additional days visiting his parents. His transportation costs are deductible in full. Four-sevenths of his meals and lodging are deductible. The next month, he and his wife spend two weeks in Honolulu. While there, he spends two days visiting with customers of his company. He spends one day flying to Lanai to visit a customer. His portion of the meals and lodging for three days and the plane travel to Lanai are deductible. None of the other expenses, including the airfare between his home and Honolulu, are deductible.

Travel expenditures (i.e. meals and lodging) associated with temporary work assignments away from your tax home may be deductible so long as the temporary assignment does not exceed one year.

Tip: You may deduct travel expenses incurred while returning home for visits during days off; however, your deduction is limited to the amount that you would have incurred for meals and lodging had you

stayed at the temporary assignment. The expenses you incur while in your hometown are not deductible.

Tip: The IRS allows reimbursement for extra days' expenses if they are incurred to take advantage of lower airfares.

Tip: Certain special rules apply to various categories of government officials and to individuals employed in a foreign country. Consult your tax advisor for more on these rules and to whom they apply.

Standard daily allowance (or per diem) for travel away from home.

Employees and self-employed individuals may deduct a standard daily allowance (or per diem) for meals while traveling away from home, provided that the amount is no greater than the Federal Meals and Incidentals rate for the locality of travel published by the United States government. The rate ranges from \$30 to \$46 a day depending on the location of travel. Three-fourths of this amount may be used for partial days of travel (e.g. the first and last days of travel where the taxpayer is not gone a full day). As with all standard allowance arrangements, only the amount of the expense is deemed substantiated. The taxpayer must still prove the time, place and business purpose of the travel.

Tip: There is not a standard allowance for lodging that a self-employed or employee can use for deduction purposes.

Employers have several standard daily allowance options that may be utilized when reimbursing travel expenses of employees or independent contractors. The options include (1) a standard allowance combining lodging, meals and incidentals based on the locality of travel, (2) a standard allowance for meals and incidentals (exclusive of lodging) based on locality of travel when actual lodging expenses are reimbursed or directly paid, or (3) a simplified high-low

method combining lodging, meals and incidentals by setting only two daily rates, one for low-cost locations and one for high-cost locations. The Federal government also publishes maximum allowable rates for travel in foreign countries. Refer to the Appendix for a summary of the current per diem rates for business-related travel.

Tip: Because lodging rates normally exceed the Federal guidelines, most employers reimburse actual expenses for lodging and per diem rates for meals (option #2 above).

Tip: Certain employees related to their employer are not allowed to use the standard allowance for meals and/or lodging.

Tip: If an employer reimburses an employee or independent contractor a per diem amount under a reliable reimbursement arrangement, as discussed later in this publication, the employer may deduct the amount reimbursed. Furthermore, the employee or independent contractor recognizes no income as a result of the reimbursement.

Tip: If the employer pays an allowance greater than the per diem rates published by the government, the employer must treat the excess as taxable compensation on the employee's W-2 (or independent contractor's 1099-MISC). Certain payroll taxes and income tax withholdings may be required on taxable amounts.

Tip: If the employee's actual travel expenses exceed the amount reimbursed under any method utilized by the employer, the employee may be able to claim an itemized deduction for the excess. Of course, the employee must have proof of the actual amounts claimed.

Tip: A special rate applies to an employer that pays a per diem allowance only for meals and incidentals to an employee in the transportation industry. Examples of transportation industry include interstate

trucking, bus, air, railroad and sea.

The rules associated with business-travel expenses, standard allowance arrangements and employee reimbursements are complex. Failure to properly account for and substantiate these expenses can result in significant additional tax, penalties and interest for both you and your employees. You should consult with your tax advisor to ensure that you are utilizing these rules to achieve the greatest tax savings and employee satisfaction.

Meal and entertainment percentage disallowance rule.

Expenses incurred for meals while traveling away from home on business are subject to the 50 percent disallowance rule as discussed above under “Meal and entertainment expenses.”

Tip: The meals and incidentals portion of the per diem rates discussed above are subject to the 50 percent disallowance rule unless the reimbursement is taxable to the recipient. If taxable to the recipient, the payer deducts the entire amount as compensation and the recipient is subject to the 50 percent disallowance rule.

Tip: Employers and/or workers in the transportation industry may be able to deduct a greater amount for meals consumed while away from home. The deductible percentage increases from 65 percent in 2002 to 80 percent in 2008 and beyond.

Foreign travel.

Business trips abroad are differentiated from domestic trips in that a portion of the transportation costs may have to be treated as a personal expense even though the trip may be primarily business in nature. The allocation of transportation costs is generally made on the basis of business days versus vacation days. Business days are:

- Days on which important business is conducted
- Transportation days (via a direct route)
- Weekends, holidays and days of delay in available transportation, which occur between business days
- Any other day when circumstances beyond the taxpayer's control preclude the pursuit of business activities.

The allocation does not have to be made if any of the following circumstances apply:

- Total time outside the United States does not exceed seven days
- Less than 25 percent of the days are non-business days
- The circumstances of the trip are such that the taxpayer had no control over arranging the date of the trip.
- The taxpayer can show that a vacation was not a major consideration in making the trip

The expenses of an employer who reimburses an employee for foreign travel are not reduced because of the above rules; however, the employee is required to report the unallowable portion as income.

Example: Mrs. Overseas flies to London and conducts business there for two days. She spends three days sightseeing and then returns home. Since the trip does not exceed one week, no allocation of travel expense is necessary as long as the primary purpose of the travel is business. The following month Mrs. Overseas again flies to London to finish her business there, timing her trip so she can spend Easter in Rome. She spends two days traveling to and from the United States, three days in London and seven days in Rome, returning directly to the United States from Rome. Plane fare from the

United States to London and return is \$1,500, and her side trip to Rome was \$500. Mrs. Overseas may deduct five-twelfths of \$1,500 as transportation and all of the cost of meals and lodging in London. If her employer reimburses her for the cost of the entire trip, she must report as income \$1,375 plus the cost of her meals and lodging in Rome (i.e. $\$1,500 \times 7/12$ personal is \$875 plus \$500 travel expenses to Rome equals \$1,375).

If you, as a business traveler, choose to take a luxury ocean liner rather than an airplane to a foreign business meeting, the deduction for this travel is limited to twice the maximum federal per diem reimbursement rate.

Domestic conventions and seminars.

Travel to conventions and seminars held in Canada, Mexico, U.S. possessions or the Trust Territory of the Pacific, or certain qualifying Caribbean countries are generally governed by the same principles as other domestic travel. Thus, travel expenses to and from a U.S. destination are deductible if the convention is primarily a business trip, but not if the trip is primarily for pleasure. Certain additional considerations apply to conventions and seminars because the taxpayer has an increased opportunity to combine pleasure with business at some meetings.

Tip: The cost of investment seminars, which relate to financial or tax planning for investors rather than to the taxpayer's trade or business, is not deductible.

Tip: Travel as a form of education is not deductible.

Foreign conventions and seminars.

Conventions and seminars held outside of the above North American areas are, as a general rule, considered personal in nature and the expenses are not deductible. An exception to this rule exists if the taxpayer can establish that the meeting is directly related to trade or business activity and that the location was reasonable in view of these factors:

- The purpose of the convention and the activities involved
- The purposes and activities of the sponsor
- The residences of the active members of the sponsor
- The places other conventions of the sponsor have been and will be held
- Any other relevant factors indicating the reasonableness of the location

Example: Mr. Atom is a research chemist and belongs to the International Society of Chemical Engineers, made up of members from a number of countries. Each year the members from a particular country are chosen to host a convention devoted to an exchange of developments in the field. The agenda is a full one. Mr. Atom attends the convention held in Holland. This trip appears to possess the characteristics required for deductibility.

The trip would not be deductible if only the members of a state society of chemical engineers attended the meeting.

Tip: The rules dealing with foreign travel are complex. Anyone contemplating deducting such a trip as a business expense is well advised to discuss it with his or her tax advisor before embarking on the trip.

You may deduct up to \$2,000 of the expenses of attending a convention, seminar, or similar meeting held on a cruise ship if you establish that the meeting is directly related to your trade or business. A cruise ship is any vessel sailing inside or outside of U.S. waters. You may deduct these expenses if: (1) the cruise ship is a vessel registered in the United States, (2) all of the cruise ship's ports of call are located in the United States or in possessions of the United States, and (3) you satisfy the reporting requirements by attaching both of the following to your return:

- A signed written statement that includes: (1) the total days of the trip (excluding the days of transportation to and from the cruise ship port), (2) the number of hours each day that you devoted to scheduled business activities, and (3) a program of the scheduled business activities of the meeting.
- A signed written statement by an officer of the organization or group sponsoring the meeting that includes: (1) a schedule of the business activities of each day of the meeting, and (2) the number of hours you attended the scheduled business activities.

Spouse and dependent travel.

The Revenue Reconciliation Act of 1993 generally eliminated the deduction for travel expenses of spouses, dependents or other individuals accompanying a person on a business trip. The only time travel expenses of a spouse, dependent or other will be allowed is when all of the following are met:

- The spouse, dependent or other is also an employee of the employer making the expenditure
- The spouse, dependent or other's travel represents a bonafide business purpose

- The spouse, dependent or other's travel expenditures would otherwise be deductible

Tip: An employer may deduct spousal travel if it is included on the employee's W-2 as compensation.

Tip: If the employer does not deduct the travel expenses associated with the employee's spouse, and the employee substantiates the bonafide business purpose for the attendance of the spouse, the cost attributable to the spouse's business attendance may be excluded from the employee's W-2 as a working-condition fringe benefit.

Listed Property Expenses.

Certain limitations are placed on the method used to claim depreciation deductions available from the use of "listed property" unless more than 50 percent of the use is qualified business use (discussed later). Listed property includes:

- Passenger automobiles and other property used as a means of transportation
- Property of a type generally used for purposes of entertainment, recreation or amusement
- Computer or peripheral equipment not used exclusively at a regular business establishment
- Cellular telephones
- Other property to be specified by the Treasury regulations

In general, use of property in a trade or business is qualified business use. Use of property in connection with investment activities, while deductible, is not qualified business use. The distinction between a trade or business or an investment is frequently difficult to make. If in doubt, the specific facts should be reviewed with your tax consultant.

Frequently, employees and independent contractors are provided the use of property as compensation. Such use will not be qualified business use unless the value of such use is included in the gross income of the person so compensated and taxes are withheld from compensation as required.

Tip: Property used by a 5 percent owner (or a related person) will not be qualified business use even if such use is compensation or the result of a lease to such person. An exception allows use of an aircraft to be qualified business use if at least 25 percent of its total use during the

taxable year is in a trade or business and is not by a 5 percent owner or related person.

An employee is regarded as being in the trade or business of being an employee; however, employees claiming depreciation deductions for listed property must further prove that the listed property is used for the employer's convenience and required as a condition of employment. These two tests must be met in fact; simply agreeing to them in writing will not suffice. Failure to meet these two tests will result in a disallowance of any depreciation deduction with respect to the listed property.

Depreciation.

An accelerated rate of depreciation may be used for property used predominantly (more than 50 percent) in a qualified business use. Failure to achieve the required percentage of qualified business use limits depreciation to an amount computed using an alternative straight-line method. For most property this will result in a slower deduction of the cost than otherwise permitted.

Tip: You should carefully monitor use of listed property and avoid its qualified business use falling below 50 percent. Otherwise, you may be required to include in your taxable income an amount representing the difference between the accelerated depreciation claimed in prior years over a recomputed amount using the alternative straight-line method.

There is a further dollar limitation on depreciation deductions claimed on most passenger automobiles, including trucks and vans. The dollar amounts of these limitations are detailed in the Appendix. These depreciation limitations are further reduced by any personal use of the automobile or by any other reduction in allowable depreciation. For example, if a

businesswoman purchases a \$20,000 automobile and her qualified business use of the vehicle is 60 percent, her first year depreciation is limited to 60 percent of the total limitation amount.

Tip: The depreciation limitation on passenger automobiles does not limit the over all depreciation claimed on the vehicle; it only extends the period of time in which the depreciation deductions may be claimed.

Tip: Regulations exempt certain automobiles from the above rules, thereby allowing a full depreciation deduction. The exemption covers certain automobiles exceeding a certain weight and those used for special purposes. Your tax advisor can help you determine which automobiles may be exempt.

In addition to deduction limitations and special reporting requirements, personal use of listed property by employees may require inclusion of the personal-use portion to be included as taxable compensation in the employee's W-2 and subject to payroll tax withholdings. The special valuation rules for reporting that personal use are beyond the scope of this publication. Additional rules, special reporting requirements and potential income inclusions apply to automobiles leased by employers and self-employed individuals. You should consult with your tax advisor for additional information.

Reimbursement Arrangements.

Accountable plans (employers and employees).

Employee business expenses reimbursed under an “accountable plan” are excluded from an employee’s income and are not required to be reported on the employee’s W-2. Further, these reimbursements are exempt from income and employment tax withholding. An accountable reimbursement arrangement must meet the following criteria:

- **Business connection.** The arrangement must provide for reimbursement of employee business expenses.
- **Substantiation.** The employee must submit adequate information to the employer to satisfy the documentation rules for travel, entertainment, business gifts or use of listed property. For other employee business expenses, sufficient information must be submitted to identify the business nature of the expense.
- **Return of excess.** The employee must be required to return any excess reimbursement that is not adequately substantiated.

Documentation of expenses or payment of excess reimbursement must occur within a reasonable period of time. Regulations indicate that the determination of a reasonable period of time will depend on the facts and circumstances. Advances made no earlier than 30 days before an expense is paid or incurred are considered made within a reasonable period of time. Similarly, expenses substantiated to the employer within 60 days after payment are considered made within a reasonable period of time. Repayment of excess reimbursements should occur within 120 days.

Non-accountable plans (employers and employees).

Advances, allowances or reimbursements under a plan not meeting the above requirements are made under a “non-accountable plan” and are included in the employee’s W-2 as taxable income. Furthermore, these payments are subject to income and employment tax withholding.

The employee must complete Form 2106 - Employee Business Expenses and include any allowable business deduction on Schedule A - Itemized Deductions. The amount of business deductions will further be limited to 2 percent of the taxpayer's adjusted gross income.

Tip: If you are going to reimburse employees for business expenses it is better to do so under an accountable plan. Otherwise, taxable reimbursements under a non-accountable plan are subject to employer payroll taxes such as FICA and federal and state unemployment. Additional employer costs may result from employee benefits being increased when such benefits are based on taxable compensation (e.g. pension plans, life insurance, disability, etc.)

Rules for independent contractors and their clients.

If you are a client or customer, you generally do not have to keep records to prove the reimbursements or allowances you give, in the course of your business, to an independent contractor for travel or entertainment expenses incurred on your behalf. However, you must keep records if you reimburse the contractor for travel and entertainment expenses incurred on your behalf and the contractor adequately accounts to you for these expenses.

If the contractor adequately accounts to you for entertainment expenses, you (the client or customer) must keep records documenting each element of the expense as discussed later in this book. Use your records as proof for a deduction on your tax return. If meal and entertainment expenses are accounted for separately, you are subject to the 50 percent disallowance rule. If the contractor adequately accounts to you for reimbursed amounts, you do not have to report the amounts on Form 1099-MISC.

If the contractor does not adequately account to you for allowances or reimbursements of entertainment expenses, you do not have to keep records of these items. You are not subject to the 50 percent limit on meals and entertainment in this case. You can deduct the reimbursements or allowances as payment for services if they are ordinary and necessary business expenses. You must report the amounts on Form 1099-MISC if otherwise required. Note that under these circumstances the independent contractor is subject to the 50 percent disallowance rule on meals and entertainment if otherwise deductible.

Tip: Taxpayers are well advised to keep these rules in mind when entering into a client/independent contractor relationship. Failure to clarify how reimbursements will be structured may result in unexpected disallowed deductions not previously considered in the overall pricing of the contract.

Record-keeping requirements.

The law specifically requires that adequate records be kept to deduct entertainment, travel, gift and listed property expenses. Without the required records, legitimate business or investment expenses are not deductible.

Record keeping starts with the person who incurs the expenditure. The person who claims the expenditure as a deduction must

keep records on file. Therefore, a company that reimburses an employee for such expenses must obtain the required records from the employee to deduct the amounts reimbursed. On the other hand, if the company does not require an accounting from an employee, but instead reports such payments on the employee's W-2 form, the employee must maintain the records to claim the deduction.

The following table lists these expenses and illustrates the type of records that should be maintained.

Tip: Receipts or invoices must be retained for all expenses of \$75 or more, and **all** hotel bills. For business expenses documented in a calendar or log, an entry must be made at or near the time of the expenditure.

A Final Note.

While these rules are complex, compliance carries with it the rewards of tax deductibility, and thus, reduced net cost of the expense. Failure to comply, however, can be extremely costly. If you wish to discuss these matters or have questions, please contact us at your convenience.

Business expenses requiring special records.	Records required.
Entertainment expenses including business meals and out-of-pocket costs incurred solely because of an actual business entertainment use of a facility.	<p>Receipt for the cost of the meal or entertainment or an account book, diary, log, expense statement, or calendar for expenditures without receipts. Records must include the following information:</p> <ul style="list-style-type: none"> • Date of meal or entertainment • Place • Identification of guests • Business relationship with guests • Nature of business discussions (including those before, during or after entertainment) • Amount (and nature of entertainment if not a meal)
Business gifts	<p>Receipts for business gifts or an account book, diary, log expenses statement or calendar for expenditures without receipts. Records must include the following information:</p> <ul style="list-style-type: none"> • Cost of the gift • Date of the gift • Description of the gift • Business benefit expected • Name and business relationship of the recipient
Business travel expenses including meals and lodging	<p>Receipts for travel expenses or an account book, diary, log, expense statement, trip sheet, or calendar for expenditures without receipts. Records must include the following information:</p> <ul style="list-style-type: none"> • Dates of travel • Days that business was and was not conducted, including weekends, holidays and delays in the business category • Place visited • Names of people visited • Business relationship • Purpose of visit • Daily detail of nature and amount of expenses <p>A per diem allowance used to reimburse employees for travel away from home that falls within the government guidelines will satisfy the substantiation requirement for the amount of the expenditure. All other elements listed above must be documented.</p>

Business expenses requiring special records.	Records required.
Foreign conventions	<p>In addition to documenting the above elements, a taxpayer traveling to a foreign convention located outside of the North American area must provide that attendance was directly related to trade or business activity and the location was reasonable in light of the following:</p> <ul style="list-style-type: none"> • The purpose of the meeting and the activities occurring at the meeting • The purposes and activities of the sponsoring organization • The residences of the active members of the sponsor and the places at which other meetings have been or will be held • Any other relevant facts indicating the reasonableness of the location
Listed property – passenger automobiles	<p>Account book, diary, log, expense statement, trip sheet or calendar. Records must include the following information:</p> <ul style="list-style-type: none"> • Name of user • Date of use • Mileage for each business use • Business purpose of the use or designation as personal or investment <p>Some exceptions to the auto record-keeping requirement do exist. Examples include corporate vehicles covered by written policy statement prohibiting or limiting personal use and certain vehicles not readily susceptible to personal use. Consult your tax advisor for more information.</p>
Listed property – other (includes computers, cell phones, etc.)	<p>Account book, diary, log, expense statement, trip sheet or calendar. Records must include the following information:</p> <ul style="list-style-type: none"> • Name of user • Date of use • Hours, days or other units of use • Business purpose of the use or designation as personal or investment <p>Computers or peripheral equipment used exclusively at a regular business establishment are exempt from these reporting requirements.</p>

Current Travel and Entertainment Information

Mileage Deduction and Rates for Business Use of Automobiles

2005 40.5¢ per mile / 48.5 ¢ per
mile Sep 1 - Dec 31

2003 36¢ per mile

2004 37.5¢ per mile

2002 36.5¢ per mile

Annual Automobile Depreciation Limits

Placed in service	Maximum Allowable Depreciation			
	Year 1	Year 2	Year 3	Year 4, etc.
2005	2,960	4,700	2,850	1,675
2004	2,960	4,800	2,850	1,675
2003	3,060	4,900	2,950	1,775
2002	3,060	4,900	2,950	1,775

See your tax advisor for autos placed in service during prior years. The above limits are based on 100% business use; therefore, if business use is less than 100%, the amounts must be reduced accordingly. Similar limitations apply to leased autos. See your tax advisor for details.

Per Diem Rates for Deemed Substantiation

(For reimbursement purposes only)

Location Per Diem Rate:

The maximum allowable rates are the rates allowed Federal government employees who are in travel status. The Federal government annually publishes a list of cities and their respective per diem rates. Whenever you travel to a particular city, you are allowed to utilize that city's per diem rate, rather than substantiating the actual lodging and meals. It is also possible to substantiate only lodging and use a per diem for meal expense. An example of the variation between available rates within the continental U.S. is as follows: Rates apply to travel on or after January 1, 2005

	Lodging	M&IE	Total
Standard rate (Anytown, USA)	\$60	\$31	\$91
Medium rate (Phoenix, AZ)			
Travel done between 01/01 - 05/31	\$121	\$47	\$168
Travel done between 06/01 - 09/30	\$75	\$47	\$122
Travel done between 10/01 - 12/31	\$103	\$47	\$150
Highest rate (Manhattan, NY)			
Travel done between 09/01-12/31	\$212	\$51	\$263
Travel done between 01/01-08/31	\$169	\$51	\$220

Because motel and hotel rates normally exceed the Federal guidelines, most employers reimburse actual expenses for lodging and per diem rates for meals. The Federal government also publishes maximum allowable rates for travel in foreign countries.

High-Low Per Diem Rate:

In lieu of using actual expenses or the specific location per diems, an employer can elect a special High-Low per diem for specific employees. This option is only available for travel within the continental U.S. If this method is selected for an employee, then that employee must use it for all travel during calendar year.

The current High-Low rates after January 1, 2005 are as follows:

High (specifically listed cities/counties)	\$226 =	\$168 L / \$58 M&IE
Low (all other locations)	\$141 =	\$96 L / \$45 M&IE

In applying either per diem method, special rules apply for partial days of travel.

Meal & Entertainment Limit for Transportation Industry

Special rules exist for taxpayers involved in the transportation industry. The transportation industry is defined as work that (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing federal M&IE rates.

These taxpayers may treat \$41 as the federal M&IE rate for any CONUS (Continental U.S.) locality of travel, and \$46 as the federal M&IE rate for any OCONUS locality of travel. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.