The Business Library — **Resource Report #9**

Rules on Travel, Auto, Meal, And Entertainment Deductions

How to Protect Them from IRS Attack

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Do You Know the Rules?

- Employees' travel, meal, and entertainment expenses.
- Restrictions on expense deductions for owners of 10% or more of the company.
- Auto and equipment depreciation and deductions.
- Reimbursement of expenses.
- Recordkeeping requirements.
- Personal and business use of company- and employee-owned autos.

The IRS carefully reviews travel and entertainment expenses, deductions, and records; particularly vulnerable are business owners and executives.

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How Owners Get Hit With Huge Bills For Back Taxes, Interest, and Penalties

The reason: Improper and undocumented travel, meals, entertainment, lodging, and auto deductions — some of the highest IRS audit areas. Compounding the problem are poor recordkeeping, non-existent receipts, and non-compliance with the rules — all of which are discovered by the IRS several years after you file your business and personal tax returns. That means the amount due the IRS often is double or triple the original taxes payable because it includes interest, penalties, a 20% negligence penalty, and possibly a 75% additional penalty if you intentionally overstated your deductions.

That's what happened to one business owner who had $18,000 in deductions denied by the IRS. The final tax bill was broadened to include denied deductions for two other family members employed by the business. The IRS' tough documentation rules also apply to family members who work for the company. By family, the IRS means your parents, children, grandparents, grandchildren, spouse, and siblings. They also must itemize and fully document their expenses. In the end, with interest, penalties, and three family members included, the tax bill was $62,000.

With that warning, we advise you to take special care to comply with the IRS rules. To help you with that task, we have compiled this list of the most common mistakes business owners make in claiming deductions and complying with the rules. These "mistakes" also happen to be the areas most closely scrutinized by the IRS.

- Owners don't establish *written* company policies for everyone in the company to follow.
- They don't make an effort to learn the rules, so they can't comply with them. They rely solely on their accountants who in turn rely on the numbers provided to them.
- They don't require their employees to fully document expenses with receipts, purpose, date, etc. Or, they let months go by before requiring

expense vouchers from the employees.

- They don't demand that a *mileage log* be kept on auto use and that it indicate the business and personal mileage use for *each* trip.

- They take their spouses on business trips and deduct all expenses.

- They don't keep *contemporaneous* records. They reconstruct records *only* after an audit notice from the IRS; that's asking for trouble. The IRS has ways of spotting after-the-fact recordkeeping.

- They attend a workshop or business convention and deduct a full week of expenses even though the workshop lasts only two days and includes only a few hours of education.

- They use a company-owned car to commute to and from work and don't reimburse or account to the company for that personal use.

- They don't personally spend time reviewing their business tax returns. They simply sign off on the accountant's deductions on all travel, entertainment, and auto use.

- They elect to pay business expenses out of their own pocket and deduct them on their personal tax return.

- They don't analyze tax options to determine which achieve greater tax savings. *Prime examples:* The choice of either the standard mileage or actual cost method for deducting auto expenses, and the choice of which year to elect the special depreciation options.

Start to correct those mistakes now by adopting a *written* company policy which requires full documentation of expenses: (a) within a specific time period (usually monthly) and (b) before the employee gets reimbursement.

For more rules and strategies to protect and maximize your deductions, and stay out of trouble with the IRS, please see the following pages.

Travel, Meals, Entertainment, and Autos: What You Can and Can't Deduct

Two good reasons it pays to stay on top of the IRS rules for claiming deductions: (a) the rules change on a pretty regular basis in terms of how much you can deduct and what you need to substantiate the deductions, and (b) you don't want to have an otherwise legitimate deduction denied by the IRS because you didn't follow their rules to the letter.

Here is a checklist of tax facts and alerts on travel, meal, entertainment, and auto expenses to help you substantiate your claims in those areas and plan for this year. Also included are *Special Rules for Business Owners* (page 8) and the *Stimulus Act of 2008* (page 11) to increase your tax deductions.

Rules for Employees, Executives, and Owners

- To obtain a tax deduction on a **business expense**, all company employees and owners *must* indicate the purpose of the expense, the individual and company visited or entertained, and the time and place. Without this documentation, the deduction will be disallowed.

- For travel and entertainment expenses, you need receipts for all **expenditures** of $75 or more. For lodging expenses, a receipt is always needed even if the amount is less than $75.

  Action alert: It's good practice to require employees to submit receipts for *all* expenses, irrespective of the amount. That sends a message to employees that complete documentation is required *before* any expenses are reimbursed.

- The IRS **mileage** deduction for business travel in 2009 is 55 cents per mile (50.5 cents for 2008). For charitable work, the deduction is 14 cents per mile (the same as 2008) and for medical and business-related relocation travel, 24 cents (19 cents for 2008). *Note*: For the last six months of 2008, the IRS increased the mileage deduction to 58.5 cents for business travel and 27 cents for medical and relocation travel.

- For car and truck **expenses,** keep a log documenting business and personal mileage and use. Keep all receipts for gas, oil, tolls, repairs, etc. This is an area the IRS looks at closely.

- Only **50%** of entertainment and meal expenses is tax deductible. The 50% rule applies principally to: (a) meals with customers, suppliers, etc. and (b) when traveling overnight on business trips. *Note:* There are exceptions to the 50% rule whereby you can deduct 100% of meal expenses. *Examples:* Cost of a company picnic or other occasional company party *or* meals on company premises for employees who work late.

For business meal deductions, there must be a substantial and bona fide business discussion during, before, or directly following the meal. Otherwise, meals and lodging expenses are usually tax deductible only if incurred while an employee is "away from home" for business purposes.

An employee is considered to be away from home if the job assignment is *temporary* and not for an indefinite period. Travel expenses in connection with employment "away from home" in a single location and lasting for one year or more are *not* tax deductible.

- Only the *face value* of an **entertainment event** ticket is tax deductible, not its fair market value or the amount charged by a scalper. *Example:* You paid a scalper $1,200 for two Super Bowl tickets for you and a customer; you can deduct only the $300 face value of each ticket. *Note:* The tax deduction for "skyboxes" is also limited to the cost of a regular bleacher seat and, as indicated, only 50% of those entertainment expenses is tax deductible.

- The costs of traveling to and attending business **seminars and conventions** are tax deductible. However, even with receipts and cancelled checks, the IRS can disallow a deduction for *sham* programs where the obvious purpose is enjoyment and relaxation, rather than education and sales.

- For **business travel**, a company can reimburse an employee based on the IRS' **per-diem rate**, which covers lodging, meals, and incidental expenses. Transportation is deductible separately. If you elect to use this method of reimbursement, an employee does not have to fully substantiate the expense; only the time, place, and business purpose is required so it saves a lot of bookkeeping for both the employer and employee. Of course, the company also can reimburse an employee 100% of all business travel expenses based on a fully itemized listing of those expenses.

The per-diem rates: For high-cost metropolitan areas, the amount is $258 per day. For low-cost areas, it's $158. For a listing of the high/low cost areas by county, see IRS Publication 1542.

Note: If an employee's expenses exceed the per-diem reimbursement, the excess may not be tax deductible by the employee because of the 2% floor on miscellaneous itemized deductions. *Reason:* To deduct unreimbursed business expenses on his or her *personal* tax return, the expenses (plus any other miscellaneous expenses such as investment expenses and tax preparation fees) are deductible only to the extent they exceed 2% of a taxpayer's adjusted gross income.

Action alert: Owners and family members generally cannot use the per-diem rate for deducting business meals and lodging. They must itemize all expenses.

- Employees are allowed to exclude from taxable income up to $120 a month for employer-provided **transportation** benefits (transit passes, van pool, etc.) and $230 per month for employer-provided **parking**. All transportation and parking benefits above these levels are taxable income to the employee and must be included on his or her W-2. *(Note:* These employee benefits are *not* available to partners, owners of limited liability companies, and more-than-2% owners in S corporations.)

- To deduct **auto expenses**, you can use the standard mileage method of 55 cents per mile for 2009 or the actual cost method in which you itemize your actual expenses: gas, oil, repairs, insurance, depreciation, etc.

Action alert: The tax math should be calculated by you or your accountant using both methods to determine which method yields the higher tax deduction. For how to do these calculations, please see *Exhibit 1:* Which Auto Deduction Method Is Best for the Company?, page 15.

Special Rules for Business Owners

Business owners and family members who work for the business have to be especially careful when getting reimbursement from the company for travel and entertainment expenses or deducting them on their business or personal tax returns. Improper and undocumented expenses can result in heavy penalties and an audit of the company's records, including the expense accounts of other company executives and employees.

- The overall **ground rule** for business owners is simple: Itemize and document *everything:* all lodging, meals, transportation, auto use, etc. Under IRS rules, this applies to any person owning 10% or more of a company and family members employed by the business. *Definition:* By family, the IRS means the owner, spouse, children, parents, grandparents, grandchildren, and siblings.

- If you **reimburse an employee** for more than 55 cents per mile, the excess reimbursement above that limit is taxable income to the employee on his or her W-2. If you reimburse an employee for the full cost of his business meals and entertainment, you are allowed to deduct only 50% of that cost on the company return.

- If an employee does not **document** travel and entertainment expenses, you are required to include the reimbursed amount on the employee's W-2. In addition, if you provide an employee with a flat expense allowance *and* do not require the employee to account to you for the expenses, you *must* include the allowance on the employee's W-2; if not, your business loses the tax deduction.

- If **your spouse** joins you on a business trip, you cannot deduct any travel expenses related to him or her accompanying you *unless* he or she is a *bona fide* employee of the company and you can prove that the spouse's presence on the business trip had a *bona fide* business purpose. Meals may be deductible, but subject to the 50% deduction previously explained on page 7. Even if you meet all of the requirements, the IRS still may question the necessity of both you and your spouse making the trip.

- You cannot use the company car to **commute** to and from work unless the value of the personal use is included as taxable income on your W-2. (There are special rules for other company employees; check with your accountant.)

- You cannot take a **personal** tax deduction for business expenses for which the company *could have* reimbursed you.

- You are responsible for your employees keeping **contemporaneous records** to substantiate all auto, meals, and travel deductions. You also are responsible for all of the recordkeeping requirements outlined on the next page.

Auto Deductions

50% business use and depreciation: To qualify for five-year accelerated depreciation, an auto must be used more than 50% for business purposes. In addition, if the value of the personal use is included in the employee's compensation, that use will count as business use. If you don't meet the 50%-use test, you have to depreciate the car using straight-line depreciation.

Luxury autos: There are special depreciation rules. For luxury autos placed in service last year, your annual deduction is limited to the following: Year 1 ($2,960), Year 2 ($4,800), Year 3 ($2,250), and Year 4 and thereafter ($1,775). These annual limits assume 100% business use and must be reduced for the percentage of personal use. Review all luxury auto purchases with your accountant before you purchase the auto.

Special rules: For qualified trucks and vans (including minivans), there's a separate depreciation schedule that allows higher annual writeoffs. In addition, for some trucks and vans that meet the weight requirement (more than 6,000 pounds gross vehicle weight) there are no depreciation restrictions. For SUVs purchased after Oct. 22, 2004, there is a $25,000 limit on the Section 179 expense deduction; check with your accountant and auto dealer.

Personal and company-owned autos: For a review of the rules on both personal and company-owned autos, please see *Exhibit 2* on page 17.

Equipment Deductions and the *New Tax Act* — please see the next page.

Equipment Deductions

Economic Stimulus Act of 2008: For 2008, the equipment expensing limit (Section 179) was increased to $250,000 (from $128,000) and the investment limit to $800,000 (from $510,000). There is a dollar-for-dollar phase out once the cost of fixed-asset additions exceeds $800,000 in 2008.

Businesses also can take a special *Bonus Depreciation* in 2008 equal to 50% of **new** equipment purchases in the year it is placed in service, before January 1, 2009. To qualify, the equipment (property) must have a depreciation life of 20 years or less. *Editor's Note*: It is very probable that all of the above will be extended by Congress for 2009. Check with your accountant.

Time your capital expenditures to take full advantage of these valuable options, which were designed to encourage business investment. For example, try to use the full $250,000 deduction by accelerating capital expenditures, particularly if you expect to exceed the annual limit the following year.

Recordkeeping Requirements

Autos. On automobile expenses, receipts should be kept to verify the purchase price of the automobile, maintenance costs, repairs, and gas, oil and parts purchases.

In addition, a detailed mileage log should record all use of *each* company car, including the driver's name, trip purpose, miles driven, and date of *each* trip. The mileage log is used to establish business versus personal use. Entries should be made at or near the time the auto is used for business purposes. However, a "round trip" may be accounted for by a single entry. *More advisories*:

- For auto expenses, the company's owner/taxpayer signing the tax return must check off a box on the income tax return indicating that adequate records have been kept. That's done via Form 4562 which is included in your business tax return.
- There are special tax rules on the use of an auto by employees who own 5% or more of the company. Check with your accountant.

Meals and Travel. If you elect to itemize all of your expenses, the ground rules are simple: Keep detailed records for all lodging, meals, transportation, etc.

As indicated, receipts for all expenses of $75 or more must be kept. On expenses under $75, except for lodging expenses, you don't need a receipt but you must record the expenses in your diary and indicate the date, purpose, amount, and the individual/company visited or entertained.

Money- and Tax-Saving Ideas

■ *Purchase vs. leasing:* Consider purchasing company cars rather than leasing them. Actually *owning* the cars can result in more years of use and in equity build-up through the eventual sale or trade-in value. On the other hand, the tax writeoffs for lease payments usually exceed the annual amount allowed for depreciation deductions.

Leasing is also advantageous when the imputed interest rate is low, say, 6% or under, and your option to purchase the car at expiration of the lease is at the wholesale value, not the retail value at that time.

■ *Personal use of company auto:* Many companies permit the personal use of company-owned vehicles, as long as a dollar value for the personal use is added to the employees' taxable income (W-2). As an alternative, you can require the employees to directly reimburse the company for their personal use. You compute the value of the personal use at 55 cents per mile; or, depending on the value of the car, you can use special IRS tables which your accountant can provide.

Note: If a company auto is used for personal purposes and the personal use is *not* treated as additional compensation to the employee, the expenses of operating the car (including depreciation) must be allocated between personal and business use, based on the miles driven each year. The amount allocated to personal use is not tax deductible by the business.

■ *Business and personal trips:* If you want your company to pay for some personal vacation expenses, consider arranging a business trip around a weekend. For example, you schedule and conduct business on a Friday and the following Monday. It's okay for your company to reimburse you for your weekend meals and lodging, including transportation to and from the business location, as long as the primary purpose of the trip is business. *Note:* Don't forget to fully document the purpose of the business meetings.

Closing Comments

Reminder: If you or any employee fail to provide proper documentation of travel, auto, or entertainment expenses, the expenses are *not* tax deductible by the company unless reported as taxable income on your or the employee's W-2s.

What to do: Avoid denied deductions and possible penalties by adopting a *written company policy* which requires full documentation of expenses by company owners and employees and submission of those expense reports on a regular, frequent schedule (e.g., on the first of each month or within 30 days of each business trip). ☐

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Need More Information?

The IRS publishes helpful *free* booklets which explain and answer the most common questions relating to travel and entertainment, the business and personal use of cars, and the per-diem rates for travel. The publications are:

- #463 — Travel, Entertainment, Gift, and Car Expenses
- #535 — Business Expenses
- #1542 — Per-Diem Rates for Travel within the continental United States

You can request any or all of the booklets by calling 800-TAX-FORM or visiting the IRS website at www.irs.gov. □

Exhibit 1

Which Auto Deduction Method Is Best for the Company?

In contrast to the *Standard Mileage Method* of 55 cents per mile for 2009, the *Actual Cost Method* allows you to deduct the *actual* expenses incurred for use of the car, e.g., depreciation, insurance, maintenance, and repairs. If you use this method, more recordkeeping is required.

Which method should you use? Here's a guideline. If your total annual business use is low, say, 5,000 miles, but your percentage business use is high (say, 80%), you will usually come out ahead by using the Actual Cost Method. This method will allow you to write off 80% of your fixed costs, e.g., insurance, depreciation, repairs, etc., which should total *more* than the $2,750 writeoff (55 cents times 5,000 miles) you would get from the Standard Mileage Method. In fact, just the cost of collision and liability insurance and depreciation deductions will most likely cover the $2,750 standard mileage deduction. Here's some comparative math to help you make a more-informed tax decision.

Let's assume your projected auto expense this year, including depreciation, is $6,000, total miles driven are 8,000 and your business use is 80% or 6,400 miles; your personal use is 20% or 1,600 miles. Based on these facts, here is a comparison of your deductions using both methods:

Actual Cost Method — 80% times $6,000	$4,800
Standard Mileage Method — 55 cents x 6,400 miles	3,520
Tax Deduction Difference	$1,280

The company's tax deduction (and your personal reimbursement from the company) is **$1,280 more** with the Actual Cost Method then with the Standard Mileage Method of 50.5 cents. And you can **multiply** those savings for each auto owned in the business.

What to do: Add up the tax deductible expenses using the Actual Cost Method and then compare that number with your deduction using the Standard Mileage Method of 55 cents per mile. Select the method which gives you the greatest tax savings.

Any restrictions? You *must* use the Actual Cost Method, i.e., you *can't* use the Standard Mileage Method of 55 cents, *if:*

- you use five or more vehicles simultaneously in your business, *or*
- you claimed *actual* expenses for a leased car, *or*
- you have already fully depreciated the auto *or* have taken the Section 179 annual expense election, e.g., $250,000 in 2008, *or*
- you have used the accelerated cost recovery system (MACRS) for the auto.

If you use the standard mileage method of 55 cents, you must reduce the tax (cost) basis of the vehicle for depreciation, which is 21 cents for both 2008 and 2009. Check with your accountant.

Reminder: For all car and truck expenses, don't forget to keep a detailed log to document business and personal mileage and use. As indicated, this is an area the IRS looks at closely. ☐

What About Personal and Company-Owned Autos?

This supplement to the auto information on the prior pages presents select facts on the use of different categories of automobiles and should be discussed with your advisers.

#1. All Autos — *Definition:* The definition of an auto under some of the rules is very broad. It can include vans, trucks, pickups, etc. Only if the vehicle clearly could not be used for personal purposes can you disregard detailed recordkeeping requirements. For example, a van that has seating for only one person and contains permanently mounted shelving can be assumed to have only business use.

#2. Employee-Owned Auto — No depreciation deduction is allowed on employee-owned autos unless use of the auto is required for the convenience of the employer and is a condition of employment.

#3. Employer-Owned Autos — *Less-than-5% owner / employee:* Personal use will be treated as business use for purposes of the 50% business-use test if the value of personal use is included in the employee's compensation or if the employer is reimbursed at a fair market rate. (Check with your accountant on the requirements to meet the 50% test.)

5%-or-more owner / employee: Personal use will *not* constitute business use for the 50% business-use test even if the employer includes the fair market value of personal use in the owner/employee's compensation or if the employer is reimbursed at a fair market rental rate.

#4. Leased Autos — Generally, the deductions for leased autos are restricted and based on the *Lease Inclusion* tables issued by the IRS.

* * *

All of the above are general guidelines; the specific rules can be more complicated. *Best advice:* Check with your accountant *before* buying or leasing any company cars which will be used partly for *personal* purposes. □

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

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