

Management Considerations

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 for 2007 on travel, meal, entertainment, and auto expenses to help you substantiate your claims in those areas, calculate your deductions, and plan for your tax filings in 2008. Also included are *Special Rules for Business Owners*.

Rules for Employees, Executives, and Owners

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

■ You need receipts for all **purchases 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 and purchases, irrespective of the amount. That sends a message to your employees that complete documentation is required *before* any expenses are reimbursed.

■ The IRS **mileage** deduction for 2007 is 48.5 cents per mile versus 44.5 cents for 2006. For charitable work, the deduction is 14 cents per mile (the same as 2006) and for medical and business-related relocation travel, 20 cents versus 18 cents for 2006.

Action alert: 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 on business trips. There are exceptions to the 50% rule whereby you can deduct 100% of meal expenses, e.g., cost of a company picnic or other occasional company party.

Action alert: For business meal deductions, there must be a substantial and bona fide business discussion during, before, or directly following the meal.

■ 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.

■ Only the **face value** of an entertainment event ticket is tax deductible, not its fair market value or the amount charged by a scalper. For example, if 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.

■ 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. Of course, the company can reimburse an employee 100% of all business travel expenses based on a fully itemized listing of those expenses. *Per-diem rates:* For high-cost metropolitan areas, the amount is \$246 per day (\$226 in 2006). For low-cost areas, it's \$148 (\$141 for 2006). For a listing of the high/low cost areas by county, see IRS Publication 1542.

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 \$110 a month (\$105 in 2006) for employer-provided **transportation** benefits (transit passes, van pool, etc.) and \$215 per month (\$205 in 2006) for employer-provided **parking**.

Action Alert: 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 48.5 cents per mile 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.

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 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. Even if you meet 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.

■ If an employee does not **document** travel and entertainment expenses, you are required to include the reimbursed amount on the employee's W-2. Also, 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.

■ You are responsible for your employees keeping **contemporaneous records** to substantiate all auto, meals, and travel deductions, as well as all of the recordkeeping requirements outlined next.

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. *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.

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).

Use this important advisory with your accountant. The rules can be more complicated. You also may want to order and review the following *free* booklets from the IRS, which explain and answer the most common questions relating to travel, entertainment, and car expenses:

- #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.

For an analysis of using the Actual Cost Method versus the Standard Mileage Method, please see Exhibit 1.

Exhibit 1: Which Auto Deduction Method Is Best for the Company?

In contrast to the *standard mileage method* of 48.5 cents per mile for 2007, 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 \$2,425 writeoff (48.5 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 \$2,425 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 – 48.5 cents x 6,400 miles	3,104
Tax Deduction Difference	\$1,696

The company's tax deduction (and your personal reimbursement from the company) is

\$1,696 more with the Actual Cost Method than with the Standard Mileage Method of 48.5 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 48.5 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 48.5 cents, if:

- you use five or more cars 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., \$112,000 in 2007, or
- you have used the accelerated cost recovery system (MACRS) for the auto.

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.

Contact: Tricia Walsh, Publishing Director
Copyright 2007 by *The Business Library*, 16 Fox Lane, Locust Valley, NY 11560
800-854-8994 • 516-671-8050 (Fax: 516-671-8077)
E-mail: triciawalsh@yourbusinesslibrary.com

How to Adjust Your Company's Financial Statements to Maximize Its Value

Even if you're not in the market to sell your business today, the concepts and examples illustrated in the Case Study which follows are crucial in understanding how to value your business to obtain the highest selling price.

As with all valuations, you start by adjusting the company's financial statements. That's even more critical for closely held businesses since their owners tend to keep their company's *reported* earnings low to avoid, defer, or save taxes. The options owners use to lower taxable income include increasing salaries, declaring bonuses, setting aside more retirement money, starting and investing in affiliated businesses, and writing off bad inventory.

You're not alone: In the 25-plus years that we have been preparing Valuation Reports for business owners, a company's *adjusted* earnings increased, on average, by about 80% (many doubled the *reported* numbers), while stockholder's equity (net book value) increased about 40% from the amount shown on the financial statements. So don't penalize yourself or limit the value of your business just because you made tax and cash flow decisions which lowered your profits in the past. In most cases, the impact of those decisions can be explained and illustrated to a potential buyer or lender by showing them the adjustments you would make to reflect your company's true profitability and equity position. And that should be done *before* starting the valuation or selling-out process.

Income Statement Adjustments

You already know many of the adjustments to make. They can include any or all of the following: (a) excess compensation paid to the company's owners/officers and family members above reasonable amounts, (b) extraordinary tax writeoffs of bad debts, unusable inventory, etc., (c) unreasonably high fringe benefits, (d) the use of accelerated depreciation and high-cost inventory valuation methods, and (e) the recapture of nonrecurring expenses incurred in one year which benefit the company over future years (e.g., printing of company sales brochures, research and development costs, establishing another sales office, etc.).

Example: If a company's *reported* pretax income is \$90,000 (\$60,000 after taxes) and these adjustments total \$70,000, the *adjusted* pretax income is \$160,000. To this figure, apply a corporate tax rate (say, 35% overall) to obtain the company's *adjusted* net income

of \$104,000 (65% times \$160,000). Thus, its *reported* aftertax income increased from \$60,000 to \$104,000.

Now, to determine the value of the business, let's apply a simple 10 price-earning's multiple (p/e) to both numbers:

$$\begin{aligned} \text{Reported Net Income: } & \$60,000 \times 10 \text{ p/e} = \$600,000 \\ \text{Adjusted Net Income: } & \$104,000 \times 10 \text{ p/e} = \$1,040,000 \\ \text{Added Company Value} & = \$440,000 \end{aligned}$$

The added value of \$440,000 represents a 73% increase in value above the company's *unadjusted* financial statements. That shows you the importance of adjusting the financial statements *before* making valuation or capital-raising decisions, as well as any other decision that either affects or is affected by the value of the business, e.g., the price you ask when selling the business.

Balance Sheet Adjustments

Do the same to the assets on the balance sheet, e.g., inventory, real property, leasehold improvements, and equipment. The reported net book values of those assets are also probably *understated* and must be adjusted upward or downward to fair market or replacement value. The extra values are then added to the company's net worth or stockholder's equity account.

Example: Let's assume that on the company's latest balance sheet, your accountant reports that the net plant and equipment value (after accumulated depreciation) is \$220,000. However, you do some research and find that the current fair market value (FMV) of the plant and equipment (if sold as is) is \$300,000. Thus, you have an *increased value* of \$80,000, which would be added to the company's stockholder's equity account, which correspondingly increases the overall value of the business.

Continued on next page

What about the replacement value? This computation is also important since it values the plant and equipment as if they had to be totally replaced today. With rising costs over the years, as well as depreciation of the assets each year, the replacement value should be substantially higher than the FMV. Thus, using an assumed replacement value of \$400,000, the increased value is \$180,000 (\$400,000 replacement value less the accountant's reported net book value of \$220,000). That \$180,000 represents an 82% increase above the accountant's reported value of \$220,000.

Who's interested in replacement values? Potential buyers of the company who want to get into its line of business or company-employed executives who want to buy the business from you. *Your selling position is:* It would cost you (the buyer) \$400,000 to replace the equipment and get to where my company is today. Furthermore, all of our assets are in place and we are fully operational. Those are very strong arguments to use in valuing the assets above the accountant's reported value.

Intangible Asset Adjustments. Don't overlook these adjustments which can further increase the value of the business and the selling price.

- Customer and supplier contracts which extend more than one year.
- Location, e.g., a retail store has a long-term lease in a mall or approved zoning variances to operate.
- Licenses, trademarks, patents, copyrights, franchise, and trade name.
- Sales literature, customer lists, software programs, special manufacturing processes, marketing know-how, favorable leases, and employment and noncompete contracts which are already in place.

Look closely at your business and you should find more unreported or written-off assets which can substantially increase the value of the business. And don't undervalue the fact that you already have an established niche in the industry, a developed customer base, and a workforce in place to increase sales and profits.

Final comments. *First*, when adjusting the company's assets to fair market or replacement value, you don't have to allow for corporate taxes on the unrealized profit. The adjusted values are what a buyer pays for or a lender lends against, e.g., the FMV of real estate.

Second, if your company is a sole proprietorship, S corporation, partnership, or limited liability company, which profits are taxed personally to the owners, you must adjust the income statements to reflect a regular (C) corporation with applicable corporate, not personal, tax rates.

Third, if the company owns an affiliate, that affiliate should be valued separately. Reason: The value on the balance sheet is the company's net cost, which could be substantially lower than the affiliate's fair market value. Again, that excess value is added to your stockholder's equity account.

Fourth, to help you analyze and adjust a company's financial statements, please see *Spread Sheets for Financial Statement Analysis*, below.

We hope these ideas are helpful. Save this important advisory for future reference when valuing, selling, or buying a business.

Contact: Tricia Walsh, Publishing Director
 Copyright 2007 by *The Business Library*®, 16 Fox Lane, Locust Valley, NY 11560
 800-854-8994 • 516-671-8050 (Fax: 516-671-8077)
 E-mail: triciawalsh@yourbusinesslibrary.com

This Action Report was written by Thomas J. Martin, publisher of The Business Library. Mr. Martin is an investment banker, valuation expert, and the author of several valuation and finance books. Over the last 30 years, he has presented scores of workshops for business associations, accounting firms, banks, and other organizations on financing, valuing, buying, and selling businesses.

Spread Sheets for Financial Statement Analysis Important Definitions

- #1. **Net working capital** is current assets less current liabilities. Current ratio is current assets divided by current liabilities.
- #2. **Net quick assets** are cash items and accounts receivable less current liabilities. Net quick ratio is cash items and accounts receivable divided by current liabilities.
- #3. **Average collection period** is accounts receivable divided by daily credit sales.
- #4. **Inventory turnover** is average inventory (beginning and end-of-year position) divided into cost of sales (or into sales).
- #5. **Accounts payable aging (days)** is accounts payable divided by daily purchases of goods and supplies.

Exhibit 2:

13 Ways to Increase a Company's Value And Its Selling Price

There are many factors which affect the level of the price-earning's multiple applied to a company's profits and thus the resulting value placed on the company.

- #1. **Growth rate:** The growth rate of company sales and profits in comparison with our national growth rate and, in particular, the growth rate of the industry the company is in. The higher the growth rate of the company and the industry in which it sells, the higher the multiple.
- #2. **Operating profits:** A company's operating profit as a percent of sales and its comparison with industry standards. For example, if the company earns 12% on each dollar of sales and the industry average is 8%, the difference of 4 percentage points supports a much higher multiple.
- #3. **Fundamentals:** Good profits and return ratios, excellent management, solid balance sheet, adequate facilities for growth, etc.
- #4. **Niche:** The company's special position in the industry, whether for products or services, geographic area covered, production efficiencies, distribution know-how, reputation, trade name, etc.
- #5. **Multiple sales opportunities:** Products or services have multiple markets and end-users, providing an opportunity for growth within current markets and from future penetration into new markets.
- #6. **Proprietary products:** Proprietary nature of the products and services, e.g., compare a company which is solely a distributor of products versus a manufacturer which has proprietary products. The more proprietary the products and services, the higher the p/e multiple to be applied to your company's profits.
- #7. **Customer list:** Breadth of the company's customer base, i.e., good distribution versus a heavy reliance on a handful of major customers. Also consider the average number of years these customers have been buying from the company, e.g., two years versus five years.
- #8. **Product mix and gross profit:** The greater the number of products the company sells, and the greater the gross profit (percentage return) on those products, e.g., 40% versus 20%, the better. The higher the return on sales, the greater the number of dollars that flow to profits and thus the greater the multiple that can be applied to those profits.
- #9. **Growth capacity:** The company's current working capital, facilities, and employee levels are adequate to meet its sales and profit projections for the next few years.
- #10. **Interim results:** If they reflect a good increase in sales and profits, e.g., your six months' results show a 30% increase in sales and profits, you can annualize the results and apply the multiple to the higher profits.
- #11. **Income projections:** The higher and more certain the projections, the higher the multiple you can apply to the company's profits.
- #12. **Same line of business:** When a buyer is rounding out a product line you already have or expanding to a geographic area you already cover. In these cases, you should first adjust the company's profits upward (costs lowered) to allow for the buyer's reduced costs of buying the company, e.g., duplicate accounting and legal fees, select administrative and sales expense, and lease/rental expenses if the buyer intends to consolidate your operations into his or her company's. In essence, you want to know the buyer's profit after acquiring your business.
- #13. **Intangible assets:** Review all intangible assets; many may have already been written off and have a zero value on the company's balance sheet. As indicated, these intangible assets can include: long-term customer and supplier contracts, high-traffic location, favorable leases, trained employees and a solid long-term management team, growth in the company's backlog, special manufacturing processes, licenses, trademarks, patents, copyrights, franchise, and/or an exclusive territory or product rights.

By carefully analyzing your company, you should find more assets which were previously written off or for which the cash was already expended. Again, these assets can add greatly to the value of the business and its selling price.