Idea of the Month – September 2005

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 2005 on travel, meal, entertainment, and auto expenses to help you substantiate your claims in those areas, calculate your deductions, and plan for next year's Tax Filings. 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 2005 is 40.5 cents per mile. For charitable work, the deduction is 14 cents per mile and for medical and business-related relocation travel, 15 cents.

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 $204 per day. For low-cost areas, it's $129. 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 $105 a month for employer-provided **transportation** benefits (transit passes, van pool, etc.) and $200 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 40.5 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 of you 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.

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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 http://www.irs.gov.

Look for **Ideas of the Month** on the Association website: www.iasm.org for October and November. The December Idea will appear in the December issue of *Structural Mover*.