



# TRAVEL AND ENTERTAINMENT

DEDUCTIONS THAT CAN SAVE YOU MONEY

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## TRAVEL AND ENTERTAINMENT: Deductions That Can Save You Money

Many businesses have travel and entertainment expenses but are not fully maximizing the tax savings associated with these costs. Sometimes, people simply overlook valuable travel and entertainment deductions. Other times, a business may be confused over the array of rules. Travel and entertainment deductions are complex, but by working with a tax professional you can use these deductions to their fullest and save on your taxes.

This guide highlights travel and entertainment deductions, along with tips you can use to avoid common mistakes.

You'll learn about:

- Business trips;
- Local transportation expenses;
- Meals and entertainment expenses; and
- Club dues and fees.

**Caution.** Many people with legitimate travel and entertainment deductions run into substantiation problems with the IRS, because they didn't keep adequate records. One of the most frequent sources of audit conflict is substantiation of expenses for travel and entertainment. Because of a history of abuse, travel and entertainment deductions must

be substantiated. The IRS wants real proof of your expenses. You have to have adequate records. If you don't, the IRS will deny your deductions.

### BUSINESS TRIPS

Travel is expensive, but, if you're traveling on business, you can deduct many of your expenses. Again, because of past abuses, you must have adequate records to substantiate these costs.

#### *Tax home*

You may only deduct traveling expenses such as food and lodging that you incur while "away from home" in conducting your business. You are not "away from home" unless your duties require you to be away from the general area of your "tax home" for a period of time that is significantly longer than an ordinary workday, and it is reasonable that you would need to sleep or rest.



Your “tax home” isn’t automatically where you are living at the moment. This can be confusing. Your “tax home” is the city or general area in which your regular or principal place of business is located or—if there is no principal place of business—it is the location of your regular and principal place of abode.

The IRS looks at three factors when determining your principal place of business:

- The time spent on business activity in each area;
- The amount of business activity in each area; and
- The amount of the resulting financial return in each area.

**Caution.** Travel from your home to a local business site is not deductible because it is considered commuting.

### **Temporary versus indefinite assignments**

When determining whether you are “away from home” you have to look at the nature of your stay and the length of time away from your principal place of business. However, you can be away from home so long that you may no longer deduct the costs of travel.

For jobs or assignments that are expected to last more than one year, your assignment location becomes your new

tax home. No travel expenses are deductible, and amounts you receive from an employer for living expenses must be included into your gross income. The determination as to whether an assignment is temporary or indefinite is made when you begin the job, but can change over time.

### **Qualifying expenses**

You are allowed to deduct a variety of expenses when you travel away from your “tax home” for business reasons. All that is required is that they be common and accepted in your trade or business and helpful and appropriate to the nature of your business. You can deduct:

- Transportation costs (for example, roundtrip airfare and the cost of getting around at your destination, whether by taxi or rental car);
- Lodging;
- Laundry (depending on the length of your stay);
- Cleaning;
- Communications; and
- Meals and tips associated with these services (but only to the extent of the overall 50 percent limit imposed on all business meals).

It’s important to keep records such as a log, diary, or notebook along with supporting documentation to not only prevent yourself from claiming a deduction for a non-deductible expense,

but also to ensure that the expenses are adequately delineated. While you may pay for a bundled set of different services such as lodging or transportation, you have to be clear about the specific individual expenses included within that bundled cost. For example, out of a hotel bill, you must separately report to the IRS the costs of each meal, entertainment, and dry-cleaning services included within that one payment.

Another very important consideration is if any part of your trip is for pleasure, you have to prorate the expenses between business and pleasure. If you don't, the IRS will.

Generally, you can only claim a tax deduction for the travel expenses you personally incur. However, your business may be able to deduct the travel expenses of an employee or business associate who travels with you for a bona fide business purpose, and who would otherwise be allowed to deduct the travel expenses. You cannot deduct the travel expenses of your spouse or dependents, however, unless their travel is also business-related.

**Comment.** If your spouse shares a hotel room with you at the same cost as single occupancy, you can deduct the full amount. If there is an additional charge, that portion cannot be deducted if he or she is there only in a non-business capacity.



Finally, your expenses cannot be “lavish or extravagant.” They must be “reasonable” in relationship to the business purpose. However, most expenses for first class travel are deductible, as well as those incurred at a deluxe restaurant or hotel as long as they are at least sometimes taken by similar businesses or if a unique profit motive can be shown.

### **Federal per diem rates/allowances**

Every year, the IRS publishes per diem rates for travel within the continental U.S. You can use the per diem rates for meals, lodging and incidental expenses in lieu of using your actual expenses.

There are three types of per diem allowances:

- Meals and Incidental Expense Only (M&IE);
- Lodging plus M&IE; and
- Incidental Expenses only.

There are also two substantiation methods:

- The “high-low” method; and
- The per diem allowance method.

The high-low method is a simplified method for determining lodging plus M&IE. The 2010 per diem rate for travel to a “high cost” locality is \$258 (\$193 for lodging and \$65 for meals and incidental expenses), which represents an increase of \$2 from the rate established for 2009. The 2010 per diem rate for travel to low-cost areas is \$163 (\$111 for lodging and \$52 for meals and incidental expenses), which represents an increase of \$5 from the rate established last year. The update applies to per diem allowances paid for travel on or after October 1, 2009.

**Caution.** The list of locations eligible for the “high cost” rate of \$258 rate changes every year. Just because a city was treated as “high cost” this year doesn’t mean it will be a high cost city next year.

IRS Publication 1542 lists all of the regular federal per diem rates for different cities and counties.

■ **Planning tip.** Although using the government rates can cut down on recordkeeping, keep in mind that the government rates are based on average costs in a particular city. Your actual costs could be higher.

**Comment.** The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other location outside of the

continental U.S. The Department of Defense sets per diem rates for non-foreign areas outside of the continental U.S., while the Department of State establishes rates in all other foreign areas.

### **Staying over**

Frequently, due to airline pricing policies, it is more economical to stay over Saturday night even though business is wrapped up on Friday. The additional lodging expense that is incurred is frequently more than offset by the lower airfare. In this case, the additional meals and lodging expenses for your stay over can be deducted entirely as part of the ordinary and necessary expenses of your trip.

**Caution.** If, on a business trip during the week, you devote one day mainly for pleasure rather than business, then you cannot deduct the expenses you incur for that day. Even though this may be a nondeductible expense that you might be willing to pay, you should be quite cautious to avoid devoting over half of the time that you spend away from home to pleasure rather than business. Otherwise, you may find that all your transportation costs are not deductible.

### **Foreign travel**

Foreign business travel is governed by a different set of rules from domestic business travel. Many of your foreign travel expenses might not be deductible if you

participate in substantial, non-business activity in the course of your trip. The IRS carefully scrutinizes foreign business travel and the rules are complex, so get professional advice.

Generally, if you travel outside of the U.S. away from home you must be prepared to allocate traveling expenses (including meals and lodging) between time spent on business and time spent on pleasure.

Important and broad exceptions to the mandatory allocation rules exist, however. No allocation is required when:

- The trip is less than one week or the time spent on personal activities is less than 25 percent of your total time away from home;
- The traveling expenses are incurred on a leg of the trip that is within the U.S. and the trip is entirely for business reasons (a purely personal side trip, however, isn't deductible even though all the travel is within the U.S.);
- You have no substantial control over arranging the business trip; or
- A personal vacation was not "a major consideration" in making the trip.

An employee traveling under a reimbursement or expense account allowance arrangement is not considered as having substantial control over the arranging of

a business trip unless the employee is a managing executive or is a 10 percent-or-more owner of the business.

**Caution.** Special, more restrictive rules govern the deductibility of expenses of attending foreign conventions, seminars, and other similar meetings.

If you are subject to the foreign travel allocation rules, you generally must allocate expenses—including meals and lodging—between business and non-business on a daily basis. Each day is either entirely for business or it is deemed a non-business day. A day counts as entirely for business if your main activity during the course of that day was the pursuit of a trade or business.

### **Conventions and seminars**

Expenses for attending a convention in the U.S. may be deductible as long as a sufficient relationship to your business exists.

**Caution.** A special rule prohibits deducting any costs of attending conventions or seminars for investment instruction or for political or social purposes.

To prove a sufficient relationship between your business and topic of the convention, the IRS allows you to compare the program or agenda of the convention to the official duties and responsibilities of your position.

### **Stockholder meetings**

Expenses for attending a stockholder meeting may be deductible as long as it is not for personal reasons and the expenses are reasonable in relation to the value of the investment.

### **Luxury water travel**

You can actually deduct expenses for luxury water travel for business, such as travel by ocean liner or cruise ship! The amount deducted, however, must meet certain restrictions. The daily deductible limit is equal to twice the aggregate per diem amount allowable to executive government employees. However, if the expenses include separately stated amounts for meals and entertainment, those amounts are subject to the 50 percent limit on meals and entertainment expense deductions before applying the daily limit. Additionally, the limit does not apply to expenses incurred to attend a convention, seminar or meeting on board the ship.

There is a special \$2,000 annual limit on deductions for expenses incurred while attending conventions, seminars or similar meetings aboard a cruise ship. Additionally, such expenses are only deductible if:

- The convention, seminar, or meeting is directly related to your business;
- The ship is registered in the U.S.;



- The ship's ports of call are all in the U.S. or U.S. possessions;
- You provide a written statement disclosing the total days of the trip, number of hours devoted to business activities and program of the meetings; and
- You provide a written statement from a representative of the group sponsoring the meeting that discloses the schedule of the meetings and number of hours you attended.

### **Commuting expenses**

Commuting expenses between your residence and a business location within the area of your tax home generally are not deductible. There are two exceptions:

1. Expenses needed to transport job-related tools and materials (sorry, your briefcase or your laptop computer is not what the law has in mind); and
2. Travel to another work location from your office at home if you use that office as your principal place of business.

**Comment.** As commuting distances become farther away, the area contained “within the area of your tax home” for defining “away from home” has grown. While driving distances of more than 75 miles is generally considered away from home, you should be careful to substantiate the business need and temporary nature of the assignment in these cases.

**Comment.** Commuting does not include travel from a first-stop job site to others during the day before returning home. Just the travel expense from home to the first stop and at the end of the day from your last job-stop to home is considered non-deductible commuting.

## MEALS AND ENTERTAINMENT

The expenses that you may incur for meals and entertainment are only deductible if they are either “directly related” to or “associated with” your trade or business.

Directly related. An expense for a meal or entertainment is “directly related” to your trade or business where:

- You had a more than general expectation of getting income (or other business benefit) at some indefinite future date;
- The main purpose of the activity was the active conduct of business; and
- You actually engaged in business with the person during the entertainment period or meal.

The IRS specifies that the main purpose of activity is not the active conduct of business where a meal or entertainment event is combined with a hunting and fishing trip, yacht cruise or pleasure boat trip. However, the main purpose will be the active conduct of business where the meal or entertainment takes place in a clear business setting such, as a hospitality room at a convention.

**Comment.** You are not allowed a deduction for payment of dues paid to golf and other clubs. Further, the IRS will not consider expenses to be directly related to a trade or business if incurred during a meeting or discussion at a golf club that includes individuals other than business associates. However, this does not prevent deductions for expenditures for a round of golf between you and other business associates with the main purpose of actively conducting business and to obtain new business from, or maintain, a business relationship with a customer.

Additionally, the IRS has also specified that meals and entertainment events that take place where there are substantial distractions that prevent the active conduct of business will fail to be directly related to a trade or business. These include:

- Meetings or discussions at nightclubs, theaters or sporting events;
- Social gatherings, such as cocktail parties; or

- Meetings with non-business associates at cocktail lounges, country clubs, golf clubs, athletic clubs, or resorts.

**Comment.** Business associates include those people with whom the taxpayer could reasonably expect to engage or deal in the active conduct of a trade or business, such as customers, clients, suppliers, employees, agents, and partners. The definition does not include persons such as relatives, social acquaintances or employees of federal, state and local governments.

**Comment.** Specifically, in instances where a salesperson leases a luxury skybox at a sports arena for more than one event, the deduction for the rental expenditure is disallowed to the extent the cost exceeds the cost of the most expensive non-luxury box seat tickets generally held for sale to the public for the same event multiplied by the number of seats in the skybox. All seats in the skybox are included in the calculations, even if the skybox is not fully occupied.

**“Associated with.”** Rather than directly obtaining income from the provision of a meal or entertainment event, these expenses may be “associated with” the active conduct of business if you can show:

- A clear business purpose, such as obtaining new business or encouraging the continuation of an existing business relationship; and

- A substantial business discussion occurring directly before or after the meal or entertainment.

Proof of a sufficient business discussion is based on the facts and circumstances of the situation. But, generally, you must be able to show you actively engaged in a discussion, meeting, negotiation, or other business transaction to get income. Additionally, while no specific length is required, it must be substantial in relation to the meal or entertainment. Furthermore, as long as the discussion occurs on the same day as the entertainment, it will be considered to have occurred directly before or after the event. Otherwise, the date, location and duration of the discussion come into play.

### **50 percent cap**

The amount allowable as a deduction for meals and entertainment is generally limited to 50 percent of the total. Meals include food and beverages consumed away from home on a business trip, in



addition to meals in your local area at which a business client is present. They also include meals consumed at a business convention or reception, business meeting, or business luncheon at a club. In all cases, the 50 percent rule is applied only after determining the amount of otherwise allowable deductions.

**Comment.** Remember: substantiate, substantiate, substantiate. You need to record the dates, times, attendance, and purpose of meals and entertainment.

**Related expenses.** Related expenses, such as taxes, tips, dining, room rental and parking fees must be included in the total expense before applying the 50 percent cap. Deductions for transportation costs to and from a business meal are not reduced.

**Exceptions.** However, there are several exceptions to the 50 percent rule. They are as follows:

- Meals and entertainment expenses reimbursed by an employer to an employee are not subject to the limit (but the employer is limited to 50 percent for determining its own tax deduction);
- Self-employed individuals are not subject to the 50 percent rule where they incur the expenses as independent contractors and are reimbursed by the client or given an allowance by the customer;

- Meals and entertainment expenses incurred as a means of advertising or promoting goodwill in the community are not subject to the 50 percent limit; and
- Sales of meals, entertainment, goods, and services to the public are not subject to the 50 percent limit.

Payment for package deals that include a ticket to a qualified charitable sports event are not subject to the limit.

**Comment.** The maximum amount of the deduction is increased to 80 percent for taxpayers subject to the Department of Transportation's "hours or service" limits. This includes transportation workers subject to the Federal Aviation Administration regulations, interstate truck operators and bus drivers, and certain railroad employees subject to Federal Railroad Administration regulations.

**Comment.** In the case of company insiders (officers, directors and 10 percent owners), the deduction is limited to the amount treated as compensation to the employee and includible in income.

### **Types of entertainment expenses**

Entertainment includes entertaining guests at night clubs, sporting events, theaters, etc. Your trade or business is considered in applying an objective test as to what constitutes entertainment.

**Comment.** While events at nightclubs and sporting events may not fulfill the “directly-related” test, they may yet be deductible under the “associated with” test.

Your deduction for entertainment expenses cannot exceed the portion that is related to the business. If there are both business and non-business expenses at the same event, you need to make an allocation. Only the business portion is deductible.

The following types of entertainment expenses are specifically not deductible:

- Club dues and membership fees, such as country clubs, golf and athletic clubs, and airline clubs;
- Expenses for using an entertainment facility you own such as depreciation, operating costs, and rent; or
- Costs of entertainment for spouses or customers’ spouses for a personal or social purpose.

## GIFTS

If you give a gift in the course of a trade or business, you can deduct a total cost of up to \$25. The gift must be given for eventual use or benefit of a person or class of persons. Additionally, incidental costs of the gift, such as engraving on

jewelry or packaging are not included in the cost for purposes of the deduction.

There are several exceptions that will not be considered gifts for purposes of the \$25 limit. These include:

- Items costing less than \$4 with your name imprinted and one of a number of widely distributed identical items; and
- Signs, display racks, or other promotional material used on the business premises.

## CONCLUSION

There are many ways that travel and entertainment costs can qualify as tax deductions. You can significantly lower your tax liability by taking advantage of the many travel and entertainment tax benefits. You must plan carefully and, most importantly, make sure that you substantiate all of your expenses.

Because the travel and entertainment tax rules are so complex, many individuals fail to realize the full extent of their deductible expenses. Consult your tax advisor to learn how you can use the travel and entertainment deductions to your maximum advantage.