



# Business Management Advisory

*For Precision Custom Manufacturers*

TX02

File: TAXES

## TRAVEL AND ENTERTAINMENT EXPENSES

### SUMMARY

#### FOOD AND BEVERAGE EXPENSES

1. A food or beverage expense is not deductible unless you establish that:
  - The meal was directly related to the active conduct of your trade or business; or
  - In the case of a meal directly preceding or following a substantial and bona fide business discussion, it was **associated** with the active conduct of your trade or business.

2. Under this standard, **no deduction is allowed unless business is discussed during, or directly before or after, the meal (except** when you travel away from home on business and have a meal alone or with persons, such as family members, who are not business-connected, and a deduction is claimed only for your meal).

You do not have to be present to deduct the cost of a meal for a potential employee who traveled to the interview.

3. The law regarding **Substantiation** of meal expenses under \$25 is required.
4. There are separate rules **disallowing lavish or extravagant expenditures for food or beverages**.
5. The law requires your **presence** or your employee's at the furnishing of the food or beverages.
6. The rules set out in (4) and (5) are subject to certain exceptions. **They do not apply to:**

- Expenses treated as compensation to an employee and as wages for the purpose of withholding tax [274(e)(2)].
- Expenses paid by you under a reimbursement or other expense allowance arrangement in connection with the performance of services [274(e)(3)].
- Recreational, etc., expenses for employees—expenses for recreational, social, or similar activities (including facilities therefore) primarily for the benefit of employees, other than employees who are highly compensated employees within the meaning of section 414(q). For purposes of this paragraph, an individual owning less than a 10-percent interest in the taxpayer's trade or business shall not be considered a shareholder or other owner, and for such purposes an individual shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4)) [274(e)(4)].
- Expenses for goods, services, and facilities made available by you to the general public [274(e)(7)].
- Expenses for goods or services (including the use of facilities) which are sold by you in a bona fide transaction for an adequate and full consideration in money or money's worth ([274(e)(8)].
- Expenses paid or incurred by you for goods, services, and facilities to the extent that the expenses are includable in the gross income of a recipient of the entertainment, amusement, or recreation who is not an employee or you as compensation for services rendered or as a prize or award under section 74. The preceding sentence shall not apply to any amount

paid or incurred by you if such amount is required to be included (or would be so required except that the amount is less than \$600) in any information return (Form 1099) filed by you [274(e)(9)].

7. Percentage reduction for meal and entertainment expenses-

- **50 percent limit.** The amount allowable as a deduction for amounts spent on meals and entertainment is limited to 50% of the amount of such expense.

This 50% reduction rule applies, for example, to food or beverage costs incurred in the course of travel away from home (whether eating alone or with others), in entertaining business customers at your place of business or a restaurant or in attending a business convention or reception, business meeting, or business luncheon at a luncheon club. Similarly, the cost of a meal furnished by an employer to employees on the employer's premises is subject to the reduction rule, whether or not the value of the meal is excludable from the employee's gross income under section 119.

Exceptions to the percentage reduction rule include:

- Where a meal expense is excludable from the gross income of the recipient as a **de minimis fringe**;
- Expenses for attendance at a **sports event** if the event meets certain requirements related to **charitable fundraising**.

**Qualified meeting.** The term "qualified meeting" means any convention, seminar, annual meeting, or similar business program with respect to which an expense for food or beverages is not separately stated, **and** more than 50% of the participants are away from home, **and** at least 40 individuals attend, and such food and beverages are part of a program which includes a speaker.

- **Situation where charges are not separated.** The effect of the percentage reduction rule **cannot be avoided by reason of the absence of separate charges**, payments or allocations as between meal and entertainment expenses subject to the rule, and business expenses that are deductible in full. **For example**, assume that a hotel charges \$200 per night for a room, that it provides dinner and breakfast free of any separately stated charge, and that the amount properly allocable to the meals (or the right to the meals) is \$50. Of the taxpayer's \$200 payment to the hotel, assuming all other requirements for a business deduction are met, **only \$175** (\$150 for the room, plus 50 percent of the \$50 allocable to the meals) is deductible.
- **Per diem expense allowance.** Similarly, if a business provides its employees with a fixed per diem amount to cover lodging and meal expenses incurred in business

travel, an allocation on a reasonable basis must be made between the meal expenses and the lodging or other expenses, and the percentage reduction rule applies to the amount so allocated to meal expenses.

- **Treatment of taxes and tips.** In determining the amount of any otherwise allowable deduction that is subject to reduction under this rule, expenses for taxes and tips relating to a meal or entertainment activity are included. For example, in the case of a business meal for which the taxpayer pays \$50, plus \$4 in tax and \$10 in tips, the amount of the deduction cannot exceed \$32.00 (50 percent of \$64).
- **Cover charges, room rents, etc.** Expenses such as cover charges for admission to a night club, the amount paid for a room which the taxpayer rents for a dinner or cocktail party or the amount paid for parking at a sports arena in order to attend an entertainment event there, likewise are deductible (if otherwise allowable) only to the extent of 50 percent under the rule. **However**, an otherwise allowable deduction for **the cost of transportation to and from a business meal** (e.g., cab fare to a restaurant) is **not reduced** pursuant to the rule.

#### TRAVEL AND ENTERTAINMENT (OTHER THAN FOOD AND BEVERAGE)

1. The 50% rule also applies to entertainment expenses (with the same exception as explained earlier).
2. **Deductions for tickets limited to face value.** The amount otherwise deductible for a ticket to an entertainment activity, before application of the percentage reduction rule, is limited to the face amount of the ticket. An exception to this limitation is provided for certain charitable sports events.
3. **Skyboxes.** The amount deductible for skyboxes or other private luxury boxes leased for more than one event is limited to the sum of the face value of nonluxury box seat tickets for the seats in the box covered by the lease.
4. **Travel as a form of education.** No deduction is allowed for expenses for travel as a form of education. For example, where a teacher of French travels to France to maintain general familiarity with the French language and culture, or where a social studies teacher travels to another state to learn about or photograph its people, customs, geography, etc.
5. **Expenses for nonbusiness conventions.** No deduction is allowed for expenses related to attending a convention, seminar, or similar meeting unless such expenses qualify under section 162 as ordinary and necessary expenses of carrying on a trade or business of the taxpayer. Thus, the law disallows deductions for expenses of attending a convention, etc. (for

example, a convention to discuss investment opportunities) where the expenses would be deductible under section 212 (relating to expenses of producing income) . The disallowed expenses to which the provision related typically include such items as travel to the site of such a convention, registration or other fees for attending the convention, and personal living expenses, such as meals, lodging, and local travel, that are incurred while attending the convention or other meeting. This disallowance rule does not apply to expenses incurred by you in attending a convention, seminar, sales meeting, or similar meeting relating to your trade or business that are deductible under section 162.

6. **Business conventions. Is the trip primarily for business?**

- **Generally.** Congress is concerned that some taxpayers may be claiming deductions under section 162 for travel and other costs of attending a convention, seminar, or similar meeting (“convention”) at which each convention participant is furnished individually with video tapes or lectures, etc., on topics related to the taxpayer’s trade or business, to be viewed at the convenience of the participant, and at which no other significant business-related activities occur during the time allotted for the convention. In such situations, the taxpayer does not participate in activities normally conducted at a business-related convention, such as participating in meetings, discussions, workshops, lectures, or exhibits held during the day, and simply views the tapes at his or her own convenience. Because permitting deductions for travel, meal or entertainments costs associated with such minimal business-related activities would allow taxpayers to treat expenditures that essentially are for vacation, recreation, or other personal purpose as business expenses. Congress clarified that no deduction is allowable under section 162 for travel or related costs (such as meals, lodging, or locate transportation) of attending such a convention.

- **Facts-and-circumstances test.** The determination of whether a trip is related primarily to your trade or business, rather than being primarily personal in nature, depends on the facts and circumstances in each case. An important fact in determining whether the trip is primarily personal is the amount of time during the period of the trip that is spent on personal activities compared to the amount of time spent on activities directly relating to your trade or business.

- **Illustration.** Assume that a four-day convention is held at a resort or vacation location, that the convention sessions (whether or not utilizing video-taped materials) are scheduled solely for two hours each evening, and that you do not engage in any non-convention business activities during the day. In such a case, you could not deduct any away-from-home expenses (travel, lodging, or meals) incurred on your trip because the travel is not related primarily to your trade or business, but could deduct any expenses properly allocable to the convention sessions, subject to the rule described above relating to furnished video-taped materials.

7. **Luxury water transportation.** The law limits the amount of deductions allowed for travel expenses by cruise ship or other luxury water transportation to twice the highest per diem generally available to employees of the federal government for travel in the United States, times the number of days in transit.

**The information provided here is by no means complete, it is merely a synopsis of key points. Each individual should carefully analyze their own situation and discuss it with their tax advisor so that full advantage can be obtained from current tax law.**

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