



Travel And Entertainment:

Deductions That Can Save You Money



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Many businesses have travel and entertainment expenses but they aren't maximizing their tax savings. Sometimes, people simply overlook valuable travel and entertainment deductions. Other times, people are confused by the rules on deducting travel and entertainment expenses. 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:

- Automobile deductions;
- Standard mileage rate/ actual cost;
- Buying versus leasing;
- "Luxury" auto depreciation;
- Business trips;
- Local transportation expenses;
- Meals and entertainment expenses; and
- Club dues and fees.

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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.

Automobile Deductions

Deducting expenses for the business use of a car or truck frequently confuses taxpayers. Many small businesspeople and self-employed individuals are caught on audit. Mistakes aren't intentional. The rules are so confusing that the IRS knows that many small businesspeople are pressed for time and they don't always keep complete records of the business use of a car or truck. However, this is a fatal mistake.

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If you use a car or lightweight truck for business, ask yourself:

- Should I use the standard mileage method or actual costs?
- What impact will the business use percentage have on depreciation if I use actual expenses?
- Should I buy or lease?
- What are the records that I need to keep to substantiate my automobile deductions?

What's deductible?

Generally, you can deduct the cost of:

- Gasoline;
- Oil;
- Tires;
- Repairs;
- Insurance;
- Depreciation (except in excess of a "luxury" auto limit);
- Parking fees and tolls;
- Licenses;
- Loan interest; and
- Garage rent.

These expenses generally can be deducted either using the "actual cost" method or the "standard mileage rate."

Caution. You can deduct only the portion of the cost that is attributable to business. To the extent you use your business vehicle for personal purposes, you need to exclude those costs from your deduction. Will the IRS just trust your "say so" on whether you used your business car for personal purposes? No, you must keep accurate mileage-and-purpose written logs for every trip. If your business is audited, this is a favorite place for the IRS to deny deductions, or at least negotiate them downward, if you don't keep meticulous records.

How much tax benefit you get from your automobile deduction depends on how you take the deduction:

- ***If you are operating your own business***, your automobile expenses are deductible as a direct deduction against your business income, either on your business's separate tax return, or on Schedule C of your Form 1040.

- ***If you are an employee whose automobile expenses are not reimbursed,*** you can deduct your automobile expenses only if you itemize your deductions and only as a miscellaneous itemized deduction subject to the two percent adjusted gross income floor, which usually will severely restrict the amount you can deduct.
- ***If you are an employee who is reimbursed by your employer,*** under a reimbursement plan that qualifies as an “accountable plan,” you don’t need to report anything on your tax return and your employer gets a business expense deduction for those expenses directly. An “accountable plan” is one that meets IRS standards for contemporaneous mileage logs and other proof.



Planning tip. Which method, standard mileage or actual cost, is the best one for you? You’ll need to crunch the numbers to decide. Most businesses find an advantage to using actual costs, but others find that the inconvenience of keeping records to prove actual expenses is not worth the savings. Often, however, for those who opt for the standard mileage rate, fear of recordkeeping is the biggest obstacle to maximizing their deduction.

Standard mileage rate or actual costs?

Using the standard business mileage method is a simple way to compute deductions for car expenses in lieu of calculating the operating and fixed costs allocable to business purposes.

Under the standard mileage method, you determine the amount of the allowable deduction by multiplying all the business miles driven during the year by the standard mileage rate.

The standard mileage rate is 44.5 cents a mile for 2006, and may be used whether you own or lease your

vehicle. The standard mileage rate is adjusted for inflation, so it usually goes up a cent or two each year. The business portion of parking fees and tolls may be deducted in addition to the standard mileage rate, if you keep receipts for them.

Caution. Timing is important! You can use the standard mileage rate only if you use it from the beginning; that is, the first year that your vehicle is used in your business. Before you purchase a new vehicle, talk to your tax advisor and decide if the standard mileage method is best in your business situation.

2005 was unusual in that it had two standard business mileage rates because of the unusual spike in gasoline prices caused by the Hurricane Katrina disaster. The rate was 40.5 cents per mile for the period January 1 through August 31, 2005, and 48.5 cents per mile for the period September 1 through December 31, 2005. Generally, however, the IRS sets one mileage rate for the entire year.

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Since depreciation is already built into the standard mileage allowance, taking any depreciation (including “section 179 expensing”) forecloses using the standard mileage on that vehicle for the duration of ownership. The standard mileage rate also cannot be taken if your business operates five or more vehicles at the same time (that puts them into the “fleet” category).



Planning tip. Any advance payments made in leasing a vehicle must be spread over the entire lease period. Payments made to purchase a car, even though denominated as lease payments, are not deductible. You may also have to include in income an “inclusion amount,” based on your lease payment, depending upon the sticker price of your vehicle. End-of-lease additional payments for “dings and dents” can qualify as deductible repair costs.

Here are some of the pros and cons of buying versus leasing:

Purchase	Or	Lease
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If you own your automobile and elect to use the standard mileage rate the first year, then you can opt to change to actual costs in future years. The only limitation is how you have to calculate the vehicle’s depreciation.

Financing your automobile purchase lets you take an interest deduction from your business income, equal to the percentage of the automobile’s business use times the yearly interest paid.

Complicated depreciation rules apply.

Your election—to use the standard mileage rate or actual costs—will be permanent for the entire lease term (including renewals).

A lease payment has an implicit interest payment, but might not require much of a down payment and has smaller monthly payments.

Depreciation is not claimed on a leased vehicle.

Buying versus leasing

The decision to buy or lease a vehicle has important tax consequences. Some people are reluctant to lease vehicles because they ultimately will not own them. Others believe that if a business uses 20 or more vehicles, leasing is the best value for their money. Your tax advisor will help you calculate the benefits and detriments of leasing.

“Luxury” vehicles

Whether you buy or lease your automobile, your business deduction is subject to the so-called luxury auto limits when you use the actual costs method, rather than the standard mileage rate.

Believe it or not, a “luxury” auto for tax purposes currently is defined to be any vehicle over \$15,200. The depreciation portion of your deduction is based on the assumption that your car only cost \$15,200. This assumption limits the amount of depreciation that you may take each year over the assumed five-year “useful life” of the vehicle.

The IRS usually releases the luxury vehicle depreciation limits for any given year by the Spring of that year.

For regular automobiles placed in service in 2005, the depreciation limits are:

Year 1 (2005)	\$2,960
Year 2 (2006)	\$4,700
Year 3 (2007)	\$2,850
Year 4 (2008)	\$1,675

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Depreciation for a vehicle in its first year is less than that allowed for its second year because of a depreciation rule called “the half-year convention” that assumes your vehicle was purchased on July 1st of the year of purchase, no matter when it was actually bought.

The IRS now exempts from the dollar limits altogether any light truck or van that is specially modified for business to preclude the likelihood of personal use.

Lease payments are fully deductible to the extent used for business, but they are subject to a special income add-back rule to accommodate the luxury auto rules. If a leased business automobile first placed in service in 2005 has a fair market value of \$15,200 or more, the lessee must add-back to income the amount determined by a table published by the IRS. Light trucks and vans are entitled to a higher, \$16,700 limit that reflects the slightly higher costs for these vehicles.

Green machines

The tax laws include special incentives to encourage consumers to purchase environmentally-friendly or “green” cars and trucks. With gasoline selling for more than \$2.00 a gallon in most parts of the country (and \$3.00 a gallon after Hurricane Katrina), demand for green vehicles is growing quickly.

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Before 2006, purchasers of hybrid vehicles were eligible for a tax deduction. Hybrids combine an electric motor with a gasoline-powered engine. The maximum deduction was \$2,000.

Congress changed the deduction to a credit in 2005. The new credit took effect January 1, 2006.

On the plus side, a tax credit is worth more than a deduction. On the negative side, the new credit is more complex to calculate than the old deduction. The credit is made up of two other credits: (1) a fuel economy credit that varies with the vehicle's rated fuel economy and (2) a conservation credit based on the vehicle's estimated lifetime fuel savings.

Caution. The credit is temporary. For most cars and trucks, it expires in 2011.

Alternative fuel vehicles. Vehicles that run on natural gas, hydrogen and other alternative fuels are eligible for a special tax credit. Fuel cell and electric vehicles also get special treatment.

SUVs

Not too long ago, consumers used to be able to take advantage of a quirk in the tax laws originally intended for construction vehicles. Individuals who purchased a truck or van with a gross vehicle weight of 6,000 pounds or more could write-off the entire cost of purchase



Planning tip. The cost of a short-term car rental is deductible in full, no matter how top-of-the-line, as long as the expense is reasonable in relation to the business purpose.

under Code Sec. 179. Many SUVs weigh more than 6,000 pounds.

In 2004, Congress enacted additional limits on SUVs built on a truck chassis and with a gross (loaded) vehicle weight of over 6,000 pounds. While they continue to be exempt from the depreciation caps on luxury vehicles, the first-year depreciation deduction that includes Code Sec. 179 expensing is limited to \$25,000.

Although this loophole is smaller, the 2004 law does not eliminate the exemption from the luxury car depreciation limitations for SUVs that have a gross vehicle weight in excess of 6,000 pounds.

Limousine and taxi fares

Limousine fares, like taxi fares, are fully deductible. What's more, these fares are deductible no matter what the price of the luxury car in which you are being chauffeured!

Substantiating deductions

You must keep adequate records to substantiate your deductions. These include:

- Purchase bill-of-sale or lease contract;
- Receipts for all maintenance and repairs;
- Total mileage driven per year, broken down into personal, commuting, and business miles; and
- Dates of each use of the automobile for business, with the purpose of the expense.

Daily log. Keeping a daily log is very important to maximize your deduction and substantiate the business use of your vehicle. If you properly keep records, you can quickly and accurately determine your deduction when tax time comes around. Also, in case you are audited, you'll be able to easily substantiate your deduction.

Your daily log should record:

- Odometer readings with each trip (multiple short trips, though, can be combined).
- Gasoline, oil and other purchases.

Fixed and variable rate (FAVR) method. An employee's car expenses will be deemed substantiated if the



Planning tip. If your travel doesn't qualify as an "away from home" trip, the transportation part of your expenses may still be deductible under the rules relating to local transportation expenses for travel between two or more job sites or locations.

Temporary Assignment

You are "away from home."

If your employment is expected to last less than one year, it is classified as a temporary assignment, regardless of whether the work that you will have to do actually exceeds a year.

Indefinite Assignment

The location of the assignment is your new "tax home."

When you work away from home, at a single location, for one year or more, your employment will be treated as indefinite and you will not be able to deduct related travel expenses.

employer reimburses the employee's expenses with a mileage allowance using a flat rate or a stated schedule that combines periodic fixed and variable payments. At least five employees must be covered by such an arrangement at all times during the calendar year, but at no time can the majority of covered employees be management employees.

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 your residence. This can be confusing. Your "tax home" is the 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 in 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.



Planning tip: Deducting travel expenses is another reason why employing your spouse can be beneficial. If the presence of your spouse fills a legitimate business need, the full cost of the spouse accompanying you on your business trip will be deductible. However, if any part of the trip is recreational, you have to prorate the expenses for you and your spouse, between business and non-business.

Caution. Travel from your home to a local business site is not deductible because it is considered commuting. But travel from your home to an out-of-town location while "away from home" is deductible.

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.

Qualifying expenses

You are allowed to deduct a variety of expenses when you travel away from your "tax home" for business reasons. 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;
- 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).

Caution. These expenses are deductible only for you. You cannot deduct the travel expenses of your spouse or dependents unless their travel is also business-related. 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.

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.

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 Meals and Incidental Expenses (Lodging plus M&EI); and
- Incidental Expenses only.

There are also two substantiation methods:

- The "high-low" method;
- The regular federal per diem; and
- rate method.

The high-low method is a simplified method for determining lodging plus M&EI. The 2006 per diem rate for travel to a "high cost" locality is \$226 (\$168 for lodging and \$58 for ME&I). The 2006 per diem rate for travel to all other locations is \$141. (\$96 for lodging and \$45 for M&EI).

Caution. The list of locations eligible for the "high cost" rate of \$226 rate changes every year. Just because a city was treated as "high cost" last year doesn't mean it will be a high cost city in 2006.

IRS Publication 1542 lists all of the regular federal per diem rates for different cities and counties. If a city or county is not specifically identified, the 2006 standard rate is \$91 (\$60 for lodging and \$31 for ME&I).

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.

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 stayover 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 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, nonbusiness 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 US 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 US 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 US);
- 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 nonbusiness, on a daily basis. Each day is either entirely for business or it is deemed a nonbusiness 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 US 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-related purposes.

The following chart compares the treatment of expenses from different types of conventions:

Cruise Ships	Foreign Conventions	Conventions in the United States
The ship must be of US registry, all ports of call are located in the US or its possessions, and the meeting has a direct relation to your business.	The meeting has a direct relation to the active conduct of your trade or business and it is reasonable to hold the meeting outside of North America.	The meeting need not deal with the specific duties of your work but must have at least a general relationship to your business.

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.

Meals And Entertainment

The expenses that you may incur for meals and entertainment are only deductible if they are directly related to, or associated with, your trade or business. **Remember:** substantiate, substantiate, substantiate. You need to record the dates, times, attendance and purpose of meals and entertainment.

Caution. “Directly related” is defined as an activity in which you have more than a general expectation of deriving a business benefit at some indefinite future time. “Associated with” allows for activities right before or after the business activity.

50 percent cap

The amount allowable as a deduction for meals and entertainment is generally limited to 50 percent of the total. 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. 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. In all cases, the 50 percent rule is applied only after determining the amount of otherwise allowable deductions.

Last year, several bills were introduced in Congress to do away with the 50 percent cap but none passed. The cap is still on the books for 2006.

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.

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.

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

The following chart contrasts the various tax treatments of entertainment related expenses—some of which are and are not deductible:

Associated Entertainment	Entertainment expenses that are associated with the active conduct of your business are deductible if they directly precede or follow a bona fide and substantial business discussion. These include goodwill expenditures for getting new business or to encourage the continuation of existing business relationships.
Entertainment Facility	In general, there is no allowed deduction for expenses, such as: <ul style="list-style-type: none"> • Yachts; • Hunting lodges; • Swimming pools; or • Tennis courts.
Club Dues	In general, no business deduction is allowed for club dues.
Entertainment-Related Meals	Generally, expenses for these meals are not deductible unless you establish the expense is directly related to the active conduct of a trade or business.

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.