

Business Entertainment

All work and no play can make Jack (or Jill) a disgruntled employee or client. So, you may decide to treat some of your top customers or valued employees to an outing as the summer draws to a close. By knowing the tax-law rules for entertainment costs, you can double your pleasure with top-dollar write-offs.

The 50-percent rule

For starters, you're generally permitted to write off 50 percent of your qualified business entertainment and meal expenses. That 50-percent rule applies to expenses paid by employers, employees and self-employed people (including independent contractors). But employees can be reimbursed tax-free for 100 percent of their out-of-pocket costs.

The 50-percent limit extends to dollars spent while traveling away from home on business, entertaining clients at your place of business or some other location or payments at a business convention, luncheon or other meeting.

For instance, you can only deduct 50 percent of the cost of:

- Taxes and tips relating to business entertainment or meal activities.
- Cover charges for admission to a nightclub.
- Rent paid for a room to hold a dinner or party.
- Parking fees at a sports arena.

To deduct something as an entertainment expense, it must be either "directly related to" or "associated with" the active conduct of your business. Here's more on those entertainment rules:

The 'directly related' test

You can treat entertainment expenses as "directly related" to your business if you meet these three conditions:

- You expect to derive income and some other specific business benefit (other than mere good will).
- You actively engage in a business meeting, discussion or some other bona fide business transaction with the person being entertained.
- The activity's principal purpose is the active conduct of your business.

Entertainment expenses typically won't qualify as a directly related expense if: you're absent from the activity, the group includes social guests or the entertainment takes place in a location where there are substantial distractions, such as a nightclub or a football stadium.

The 'associated-with' test

It's often difficult to qualify for "directly related" entertainment deductions. But you may have an easier time deducting entertainment expenses that are "associated with" your business. This test is much easier to pass. All you have to do is meet these two conditions:

1. The activity must have a clear business purpose, such as the intent to maintain a business relationship.
2. The entertainment must directly precede or follow a "substantial business discussion."

What's a "substantial" business discussion? It occurs when you engage in an activity to derive a business benefit. But you don't necessarily have to spend more time on business than pleasure.

Example: Say you wrap up a profitable business deal with a client on Friday afternoon. Then you treat the client to a golf outing and dinner on Saturday. *Result:* Since the entertainment is "associated with" your business, you're entitled to deduct 50 percent of the expenses.

The entertainment must directly precede or follow the business discussion. For out-of-town clients, the day before or after the meeting will do the trick.

How to report your expenses

To write off entertainment and meal expenses, first determine the amount of your qualified expenses. Then, divide the total expenses in half (unless a special exception applies) to arrive at the deductible amount.

If you're an employee and you're not fully reimbursed for entertainment expenses, you must complete Form 2106. You can deduct your out-of-pocket costs as miscellaneous expenses on Schedule A of Form 1040. You can only write off those expenses after they exceed 2 percent of your adjusted gross income.

If you're self-employed, deduct 50 percent of your business entertainment expenses (unless a special exception applies) on Schedule C.

The IRS often challenges deductions for entertainment expenses, so keep accurate and detailed records.

Tip: Keep a log that cites the entertainment place and date, the amount, the business reason behind the entertainment and the person (or people) entertained. If the entertainment is associated with your business, describe the substantial business discussion that occurred.

Deduct costs at 'entertainment facilities'

The rules for entertainment facilities are tough with a capital "T."

In short, you generally can't deduct the costs associated with a facility—such as depreciation or rent, maintenance and insurance—as entertainment expenses.

The definition of an "entertainment facility" can include any property that you own, rent or use for entertainment. This includes yachts, hunting lodges, fishing camps, tennis courts, bowling alleys, cars, airplanes, apartments, hotel suites and vacation homes.

Strategy: Entertain clients at a facility when it suits your purposes. Although none of the operating expenses are deductible, you can still write off out-of-pocket expenses that qualify as associated with entertainment.

Example: Suppose you invite clients onto your boat after a substantial business discussion. You can't write off the boat's annual depreciation or upkeep, but you can deduct the cost of food, drinks and fuel to run the boat

and other expenses such as fishing bait.

Tip: If you use the facility primarily for the employees' benefit, it's exempt from the usual entertainment facility rules.

Example: If your company owns a cabin retreat, you can deduct depreciation attributable to business use as long as employees use the place at least 50 percent of the time.

Write off 100 percent of companywide events

You can typically deduct only 50 percent of your qualified entertainment expenses. But you should be aware of one key exception to that rule: If you invite the entire work force to a get-together, you can deduct 100 percent of the cost. Just make sure you don't discriminate in favor of higher-ups.

For instance, if you hold a Labor Day barbecue or end-of-summer bash for all employees, you can write off the full cost as a business expense.

Staying at home? Max out your deductions

You don't have to leave home to qualify for business entertainment deductions. You can write off costs to entertain clients in your own abode if it's associated with your business.

Strategy: Shape your guest list for the occasion. The more business guests you invite, the bigger your entertainment deduction.

Let's say you throw a catered dinner party costing \$2,000 to celebrate signing a major contract. You invite the two principals and the three client managers—plus their spouses—and four couples who are just close friends. You and your spouse complete the group.

Of the 20 party guests, 12 are business guests, including the spouses. Since \$1,200 qualifies as business entertainment, you can write off 50 percent of those costs, or \$600.

Tip: The 50 percent limit doesn't apply to entertainment for the company's rank and file (*see box on page 4*). So, you can deduct all the costs of a home party if all employees are invited.

How lavish is *too* lavish for Uncle Sam's taste?

You're not permitted to write off entertainment expenses that are "lavish and extravagant." But that doesn't mean you can't go first-class ... when it's appropriate.

Example: A real estate developer threw a year-end bash, inviting only real estate agents who sold at least two homes. It was a lavish affair, costing \$350,000 and featuring a performance by Barbara Mandrell.

Despite the high price tag, a court ruled that he could deduct the cost as business entertainment. Reasons: He had no other motive for throwing the party other than promoting home sales. (*R.G. Moore, DC-VA., 96-2 USTC 50,413*)