

BUSINESS MEALS AND ENTERTAINMENT

The purpose of this letter is to advise you of the rules for deducting business meals and entertainment expenses. This type of expense requires you to jump through several extra hoops to qualify as deductible and is subject to limitations. Nevertheless, if you pay careful attention to rules outlined below, the expenses should qualify as deductible. Four levels of tests must be satisfied.

(1) Ordinary and necessary business expenses.

All business expenses must meet the general deductibility requirement of being “ordinary and necessary” in carrying on the business. These terms have been fairly broadly defined to mean customary or usual, and appropriate or helpful. Thus, if it is reasonable in your business to entertain clients or other business people you should be able to pass this general test.

(2) “Directly related” or “associated with”.

The business meal or entertainment must be either “directly related to” or “associated with” the business. “Directly related” means involving an “active” discussion aimed at getting “immediate” revenue. Thus, a specific, concrete business benefit is expected to be derived, not just general goodwill from making a client or associate view you favorably. And the principal purpose for the event must be business. Also, you must have engaged actively during the event, via a meeting, discussion, etc. The directly related test can also be met if the meal or entertainment takes place in a clear business setting directly furthering your business, i.e., where there is no meaningful personal or social relationship between you and the others involved. Meetings or discussions that take place at sporting events, night clubs, or cocktail parties—essentially social events—would not meet this test.

If the “directly related” test cannot be met, the expense may qualify as “associated with” the active conduct of business if the meal or entertainment event precedes or follows (i.e., takes place on the same day as) a substantial and bona fide business discussion. This test is easier to satisfy. “Goodwill” type of entertainment at shows, sporting events, night clubs, etc. can qualify. The event will be considered associated with the active conduct of the business if its purpose is to get new business or encourage the continuation of a business relationship. For meals, you (or an employee of yours) must be present. That is, for example, if you simply cover the cost of a client's meal after a business meeting but don't join him at it, the expense does not qualify.

(3) Substantiation.

Almost as important as qualifying for the deduction are the requirements for proving that it qualifies. The use of reasonable estimates is not sufficient to stand up to IRS challenge. You must be able to establish the amount spent, the time and place, the business purpose, and the business relationship of the individuals involved. Obviously, you must set up careful and detailed record-keeping procedures to keep track of each business meal and entertainment event and to justify its business connection. For expenses of \$75 or more, documentary proof (receipt, etc.) is required.

(4) Deduction limitations.

Several additional limitations apply. First expenses that are “lavish or extravagant” are not deductible. This is generally a “reasonableness” test and does not impose any fixed limits on the cost of meals or entertainment events. Expenses incurred at first class restaurants or clubs can qualify as deductible. More importantly, however, once the expenditure qualifies, it is only 50% deductible. Obviously, this rule severely reduces the tax benefit of business meals and entertainment. If you spend about \$50 a week on qualifying business meals, or \$2,500 for the year, your deduction will only be \$1,250, for tax savings of around \$300 to \$400.

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