

Business meals and entertainment

Requirements for deducting business meals and entertainment expenses can be confusing. 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.

- (1) **Ordinary and necessary business expenses.** All business expenses must meet the 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.”** A second level of test specially applicable to meals and entertainment expenses must also be satisfied. Under them, 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 principle 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 even 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 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 procedure 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 \$50 a week on qualifying business meals, or \$2,500 for the year, your deduction will only be \$1,250.

See the following page for a quick reference guide.

Types of expenses	Fully deductible	Subject to 50% limitation	Examples
Employee business related events			
Business meetings		X	Lunch with coworker or client to discuss business
Out of office meal while attending training or professional meeting		X	Dinner paid for by employee and reimbursed by employer after a training seminar
Meal and entertainment for highly compensated employee		X	Dinner / entertainment exclusively for managers at county club for recreational purposes
Meal for occasional office meeting for the convenience of employer	X		Lunch ordered for quarterly department meeting
Meal for occasional large group sales or promotional meeting	X		Lunch for large group during sales seminar hosted at a hotel or conference center
Meal during conferences, seminars or training schools	X		Lunch provided by employer at a training seminar hosted at a hotel or conference center
Occasional in office working meals	X		Dinner ordered and paid for by the employee while working overtime and reimbursed by employer
Nominal food and beverages	X		Bagels, doughnuts, coffee and drinks provided during meetings or social gatherings
Employee out of town expenses			
Out of town travel not treated as compensatory		X	Reimbursement to employee not included in employee's compensation for meal expense incurred on business trip
Out of town travel treated as compensatory	X		Meal expenses incurred during a business trip included in employee's compensation
Travel and lodging	X		Mileage, airfare and hotel for out of town business
Client business related events			
Client business meetings		X	Business dinner or golf outing to develop client relationship
Employee social events			
Meals and entertainment incurred for social or recreational purposes primarily for the benefit of employees other than highly compensated employees	X		Retreats for employees to encourage team building Summer outing for employees and family Holiday part for employees and family Employee happy hour
Meal expense if for the benefit of highly compensated employees	X		Celebratory dinner for an executive to commemorate an achievement
Miscellaneous			
Qualified charitable events for employees and clients	X		Tickets for employees or clients to professional golf tournament that benefits charity
Nondiscriminatory events that recognize individual or group achievements	X		Retirement luncheon to celebrate employee's years of service Rewards dinners