

*Section 8*

## **BUSINESS TRAVEL, ENTERTAINMENT, AND GIFTS**

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### *Introduction*

In general, an S corporation may deduct its ordinary and necessary expenses for business travel, entertainment, and gifts. Travel expenses include the cost of transportation, lodging, meals, and incidentals such as telephone, laundry, and tips. To claim the deduction, the corporation must maintain detailed records documenting the nature and amount of these expenses. The deduction is claimed on page 1 of Form 1120S, line 19 as “Other deductions.”

This section details how to report and document the expenses.

### *The Accountable Plan for Reimbursement of Employee Business Expenses*

Travel and entertainment expenses may be paid by corporate credit card, in which case they are charged directly to the corporation. Alternatively, the expenses may be paid by the employees, who are subsequently reimbursed by the corporation. In both of these cases, most corporations adopt an “accountable plan,” which requires the following:

1. the employee must pay or incur deductible expenses while performing services as a corporate employee;
2. the employee must “adequately account” for these expenses to the corporation within a reasonable period of time; and
3. the employee must return to the corporation any excess reimbursements.

To adequately account for travel and entertainment expenses, the employee must provide written documentation that answers the following questions:

- when, where, and why was the expense incurred;
- how much was spent;
- and in the case of entertainment, what was the business relationship of the individuals being entertained.

In addition, the employee must provide receipts for lodging expenses. Receipts for other expenses, such as meals and entertainment, are required only if the expense equals or exceeds an amount established by the IRS. For expenses other than lodging incurred after September 30, 1995, the amount is \$75.<sup>1</sup>

To satisfy these documentation requirements, most S corporations have employees prepare formal trip reports, expense reports, or mileage logs or diaries detailing the type and amount of business travel and entertainment expense. Figure 8-1, excerpted from IRS Publication No. 463, *Travel, Entertainment, Gift, & Car Expenses*, indicates the information that is required to adequately account for business travel, entertainment, gift, and automobile expenses.

**FIGURE 8-1**  
**Elements to Prove Certain Business Expenses**

Element to be proved (1)	Expense			
	Travel (2)	Entertainment (3)	Gift (4)	Transportation (5)
<b>Amount</b>	Amount of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories, such as taxis, daily meals for traveler, etc.	Amount of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Cost of gift.	(1) Amount of each separate expense, including cost of the car; (2) Mileage for each business use of the car; and (3) Total miles for the tax year.
<b>Time</b>	Date you left and returned for each trip, and number of days for business.	Date of entertainment or use of a facility for entertainment. For meals or entertainment directly before or after a business discussion, the date and duration of the business discussion.	Date of gift.	Date of the expense or use.
<b>Place</b>	Name of city or other designation.	Name and address or location of place of entertainment, or place of use of a facility for entertainment. Type of entertainment if not otherwise apparent. Place where business discussion was held if entertainment is directly before or after a business discussion.	Not applicable.	Name of city or other designation if applicable.
<b>Description</b>	Not applicable.	Not applicable.	Description of gift.	Not applicable.
<b>Business Purpose</b>	Business reason for travel or the business benefit gained or expected to be gained.	Business reason or the business benefit gained or expected to be gained. Nature of business discussion or activity.	Business reason for giving the gift or the business benefit gained or expected to be gained.	Business reason for the expense or use of the car.
<b>Business Relationship</b>	Not applicable.	Occupations or other information—such as names or other designations—about persons entertained that shows their business relationship to you. If all people entertained did not take part in business discussion, identify those who did. You must also prove that you or your employee was present if entertainment was a business meal.	Occupation or other information—such as name or other designation—about recipient that shows his or her business relationship to you.	Not applicable.

If an S corporation reimburses employees pursuant to an accountable plan, it is permitted to deduct the reimbursements as business travel and entertainment expense, subject to certain limitations discussed below. The employees are not required to include the reimbursements in their taxable compensation. The corporation keeps the employees' accountings (such as the expense reports) as documentation of its deductible expenses.

**EXAMPLE 1:** Trucker Corporation reimburses its employees for business travel and entertainment expenses using an accountable plan. The employees pay the expenses, submit expense reports satisfying the IRS documentation requirements to the corporation's payroll office, and are reimbursed. During the year, the corporation reimbursed its employees for the following expenses:

Airfare—actual	\$2,200
Lodging—actual	2,600
Rental cars—actual	500
Taxi fares—actual	<u>150</u>
Total*	<u>\$5,450</u>

\*Meals are intentionally excluded from this example and will be covered below.

The corporation can deduct the \$5,450 as business travel expense. The deduction is claimed on page 1 of Form 1120S, line 19, "Other deductions." The employees are not required to report the reimbursements as taxable compensation.

### *Limitation for meals and entertainment*

In general, an S corporation may deduct 50% of its business meal and entertainment expenses.

**EXAMPLE 2:** Magna Corporation reimbursed its employees for the following business travel and entertainment expenses using an accountable plan:

Air fare—actual	\$ 500
Lodging—actual	900
Meals—actual	300
Entertainment—actual	<u>400</u>
Total	<u>\$2,100</u>

The corporation may deduct \$1,750 of business travel and entertainment expenses, consisting of the \$500 of air fare, \$900 of lodging, \$150 (0.5 x \$500) of meals and \$200 (0.5 x \$400) of entertainment. The \$2,100 of reimbursements are nontaxable income to the employees.

### ***Deductibility of entertainment activities***

Entertainment includes virtually any social or enjoyable activity, such as in-town business meals with clients and customers, entertaining guests at cocktail lounges, sporting events, night clubs, theatre and musical events, and an afternoon of golf or tennis at the local club. To be deductible, the entertainment must either be “directly related to” or “associated with” the corporation’s business, defined as follows:

If the primary purpose of an entertainment activity is the active conduct of business and, in fact, a business discussion, transaction, negotiation, etc., takes place during the activity, then the entertainment is “directly related to” the corporation’s business.

If an entertainment activity fails to meet the “directly related to” test, but a substantial business discussion, negotiation, transaction, etc., takes place on the same day as the activity, the entertainment is “associated with” the corporation’s business.

**EXAMPLE 3:** Accountants, Inc. performs small business accounting and tax services. On Friday morning, employee Joe met with a client to discuss year-end tax planning. Later that day, Joe paid for a golf game with the client at the country club. Because the golf match took place on the same day as a significant business discussion, it satisfied the “associated with” requirement for the deductibility of business entertainment.

### ***Exceptions to the 50% limit***

The 50% limit does not apply to all expenditures for meals and entertainment. For example, expenses for recreational or social activities primarily for the benefit of employees, such as company picnics, are fully deductible. The cost of providing food and beverages to employees as a de minimis fringe benefit, such as the cost of an occasional overtime meal to enable an employee to work overtime and the cost of coffee, soda, and doughnuts provided to employees, is also fully deductible. If an employee is subject to the Department of Transportation’s hours of service limits, the corporation may be permitted to deduct 65% of the cost of the

employee's meal reimbursements for 2002. For additional information on exceptions to the 50% limit, see Publication 535, *Business Expenses*, and IRC Section 274(n).

## *Fixed Allowances for Business Expenses*

### *Per diem allowances*

An S corporation may reimburse employees for out-of-town lodging, meals, and incidental expenses using a per diem allowance.<sup>2</sup> If the allowance does not exceed the federal per diem rate for the locale of travel, it is deductible by the corporation, subject to the 50% limit for meals, and non-taxable to the employee as a business expense reimbursement. The federal per diem rates are published at [www.policyworks.gov/perdiem](http://www.policyworks.gov/perdiem).

When a per diem rate is used for lodging, meals, and incidental expenses, an amount equal to the federal M&IE rate for the locale of travel is treated as an expense for meals, subject to the 50% limit. If the corporation uses a per diem rate that is less than the federal rate, it may allocate 40% of the allowance to meals.

The use of a per diem allowance greatly simplifies the adequate accounting requirement for the employee. The employee is required to document the time, place, and business purpose of the travel. However, the employee is not required to document the amount of each expense for meals and lodging.

**EXAMPLE 4:** Shallow Corporation reimburses its employees for business travel expenses using an accountable plan. However, instead of reimbursing employees for the actual amount of out-of-town lodging, meals, and incidental expenses, the corporation reimburses them using the federal per diem allowance for the locale of travel. During the current year, the corporation reimbursed its employees for the following expenses:

Air fare—actual	\$3,100
Lodging and meals—per diem	3,000
Rental car—actual	<u>350</u>
Total	<u>\$6,450</u>

Because the corporation reimburses lodging and meals using a per diem rate, the employees are not required to document the amount of their

lodging and meal expenses. They are required to document the time, place, and business purpose of their travel, and they must adequately account for the rest of their expenses, as explained in the IRS table (see Figure 8-1, page 182).

The corporation may deduct the \$6,450 as business travel, subject to the 50% limitation on the meal portion of the per diem allowance. The employees are not required to report the reimbursements as taxable compensation.

### ***Standard meal allowance***

As an alternative to a single per diem covering lodging, meals, and incidental expense, an S corporation may reimburse employees for the actual cost of their out-of-town lodging but use a standard daily allowance for meals and incidental expenses (M&IE allowance). The amount of the allowance varies based upon the locale of travel. The rates are published on the Internet at [www.policyworks.gov/perdiem](http://www.policyworks.gov/perdiem). If the allowance does not exceed the allowance authorized by the IRS for the locale of travel, it is deductible by the corporation as a business expenses, subject to the 50% limitation for meals, and is non-taxable to the employee as a business expense reimbursement. Furthermore, employees are not required to document the amount of their out-of-town meal expenses. The standard allowance must be prorated for travel days of less than 24 hours.<sup>3</sup> For details, see Publication 1542.

For travel before 2003, the term “incidental expenses” includes laundry and fees and tips for services, such as baggage handling. It does not include the cost of telephone calls.

### ***Related-party rules***

Revenue Procedure 2002-63, I.R.B. 2002-41, discusses specific provisions applicable to per diem allowances paid for 2002. Per the revenue procedure, a per diem allowance for lodging, meals, and incidental expenses cannot be used to substantiate the expenses of a “related party,” defined as a corporate employee who owns more than 10% of the corporation’s stock. Under the accountable plan rules, these shareholder-employees must account to the corporation for the actual amount of their lodging and meal expenses, as discussed at the beginning of this section.

The standard meal allowance may be used to substantiate the meal expenses of a related party, provided the employer reimburses the employee for actual

lodging expenses based on receipts submitted to the corporation or satisfies other lodging-related requirements discussed in the revenue procedure.

### ***Standard mileage allowance***

Many S corporations reimburse employees for business use of their cars based on a standard mileage allowance. If the allowance does not exceed the IRS-approved rate, the corporation deducts the expense and the employee has a nontaxable reimbursement. The employee is required to account to the corporation for the number of business miles driven and the time, place, and business purpose of each trip. However, the employee is not required to account for the amount of his or her automobile expenses. The standard mileage rate for 2002 is \$.365/mile.

### ***The Nonaccountable Plan for the Reimbursement of Employee Business Expenses***

If an S corporation reimburses employees for business expenses without requiring an adequate accounting and/or permits employees to keep excess reimbursements, it has a nonaccountable plan for the reimbursement of employee business expenses. Reimbursements made under a nonaccountable plan are taxable compensation to employees.

If an S corporation reimburses its employees for business travel and entertainment using a nonaccountable plan, it does not deduct the reimbursements as travel and entertainment expenses on line 19. Instead, the reimbursements are deductible as compensation expense.

**EXAMPLE 5:** Sammy Corporation reimburses its employees for business travel and entertainment expenses using a nonaccountable plan. The employees receive a flat expense allowance of \$2,000 per month, for which they submit no documentation to the corporation.

The expense allowances are included in the employees' taxable compensation. The corporation deducts the expense allowances as compensation expense.

### ***Business Gifts***

The deduction for business gifts is limited to \$25 per person. Special rules apply to employee achievement awards.<sup>4</sup>

## Nondeductible Expenses

The following expenses are nondeductible on Form 1120S:

- dues for membership in a business, social, or recreational club;
- travel expenses of a spouse or other family member accompanying a corporate employee on business travel;
- lavish and/or extravagant travel and entertainment expenses;
- the cost of entertainment facilities, such as a yacht.<sup>5</sup>

Although club dues are nondeductible, an S corporation may deduct the cost of business meals and entertainment at a club. Likewise, the cost of entertainment facilities is nondeductible, but the cost of meals and entertainment at an entertainment facility is a deductible expense.

**EXAMPLE 6:** Rider Corporation, which maintains a corporate membership at a local country club, incurred the following club expenses:

Dues	\$1,000
Business entertainment	2,500

The \$1,000 of dues is a nondeductible expense. However, the corporation may deduct 50% of the cost of the entertainment, or \$1,250.

### NOTES

1. For additional information, see Notice 95-50, IRB 1995-42.
2. Per diem allowances are discussed in IRS Publication 535, *Business Expenses*, and IRS Publication 1542, *Per Diem Rates*. Per diem rates are published on the Internet at [www.policyworks.gov/perdiem](http://www.policyworks.gov/perdiem).
3. The standard meal allowance is discussed in IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*.
4. IRS Publication 535, *Business Expenses*, discusses employee achievement awards.
5. However, if an S corporation pays club dues and/or spousal travel expenses for an employee, the corporation may characterize the benefits as taxable employee compensation. In that case, the corporation may claim a deduction for the benefit, and the employee reports taxable compensation income. For additional information, see Section 274(e)(2) and Reg. Section 1.274-2(f)(2)(iii).

**QUIZ 1 BUSINESS TRAVEL, ENTERTAINMENT, AND GIFTS**

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*Problem I.*

Mark each statement True or False.

- 1.** In general, an S corporation may deduct 50% of the cost of business meals and entertainment.  
a. True      b. False
- 2.** If an S corporation reimburses its employees for business travel and entertainment using an accountable plan, the reimbursements are nontaxable to the employees.  
a. True      b. False
- 3.** If an S corporation reimburses employees for business travel and entertainment using a nonaccountable plan, the reimbursements are taxable income to the employees.  
a. True      b. False
- 4.** An S corporation must keep detailed records substantiating the deduction for business travel and entertainment expenses.  
a. True      b. False
- 5.** The deduction for business gifts is limited to \$25 per person.  
a. True      b. False
- 6.** If an S corporation uses a country club exclusively for business entertainment, it may deduct the country club dues.  
a. True      b. False

- 7.** To deduct business entertainment, an S corporation must document that a significant business discussion or transaction occurred during the entertainment activity.
- a. True      b. False
- 8.** If it is customary for spouses to accompany corporate employees on business, an S corporation may deduct the travel expenses of both an employee and his or her spouse.
- a. True      b. False
- 9.** An S corporation may use a standard mileage allowance to reimburse employees for business use of their cars.
- a. True      b. False
- 10.** An S corporation may deduct 100% of the cost of lodging for employees traveling away-from-home overnight on corporate business.
- a. True      b. False

*Problem II.*

Multiple choice. Circle the correct answer.

- 1.** Benton Corporation reimbursed the following employee business expenses under an accountable plan:

Airfare—actual	\$1,600
Rental car—actual	800
Meals—actual	1,500
Lodging—actual	<u>3,500</u>
Total	<u>\$7,400</u>

What is the corporation's deduction for business travel and entertainment?

- a. \$7,400      b. \$3,700      c. \$6,650      d. \$7,100

- 2.** Clark Corporation reimbursed the following employee business expenses under an accountable plan:

Meals and lodging—per diem	\$ 8,200
Entertainment—actual	2,000
Business mileage—\$0.31/mile	<u>3,100</u>
Total	<u>\$13,300</u>

The per diem allowance did not exceed the federal per diem for the locale of travel. Forty percent (40%) of the per diem was allocated to meals. What is the corporation's deduction for business travel and entertainment?

- a. \$10,660    b. \$13,100    c. \$12,100    d. \$6,550
- 3.** Supra Corporation paid country club dues of \$3,500. The club was used exclusively in connection with the corporation's business. In addition to the dues, the corporation paid \$9,300 for business meals and entertainment at the club. How much of the country club expense is deductible on the corporation's return?
- a. \$9,300    b. \$4,650    c. \$6,400    d. \$8,150
- 4.** Major Corporation pays its salespeople an expense allowance of \$1,500 per month. The employees are not required to account to the corporation for their expenses. Which of the following statements is correct?
- a. The salespeople must include the expense allowances in their compensation income.
- b. The tax law requires the salespeople to account to the corporation for the amount of their business expenses.
- c. The corporation may deduct the expense allowances as business travel and entertainment expense.
- d. The corporation may deduct 50% of the expense allowances as business travel and entertainment expense.

- 5.** Super Corporation spent \$500 on business gifts for clients, as outlined below:

Client A: \$ 90

Client B: \$220

Client C: \$170

Client D: \$ 20

What is the corporation's deduction for business gifts?

- a. \$500      b. \$250      c. \$100      d. \$95

**QUIZ 1 Solutions and Explanations**

*Problem I.*

- 1.** True
- 2.** True
- 3.** True
- 4.** True
- 5.** True
- 6.** False  
Country club dues are nondeductible.
- 7.** False  
If a significant business discussion, transaction, etc., takes place on the same day as the activity, the entertainment is “associated with” the corporation’s business and its cost is deductible.
- 8.** False  
In general, an S corporation may not deduct spousal travel expenses.
- 9.** True
- 10.** True

*Problem II.*

- 1. c**  
The corporation can deduct 100% of the airfare, rental car, and lodging and 50% of the meals.
- 2. a**  
60% of the per diem ( $0.6 \times \$8,200$ ) is allocated to lodging and is fully deductible. 40% of the per diem ( $0.4 \times \$8,200$ ) is allocated to meals and is 50% deductible. The entertainment is 50% deductible. The business mileage is 100% deductible.
- 3. b**  
The dues are a nondeductible expense. Fifty percent (50%) of the cost of the meals and entertainment, ( $0.5 \times \$9,300$ ) is deductible.
- 4. a**  
The corporation has a nonaccountable plan for the reimbursement of employee business expenses. The employees must include the reimbursements in their taxable income, and the corporation deducts the reimbursements as compensation expense.
- 5. d**  
The deduction for business gifts is limited to \$25 per person. Therefore, the corporation deducts \$25 each for clients A, B, and C, and \$20 for client D.

**QUIZ 2 BUSINESS TRAVEL, ENTERTAINMENT, AND GIFTS**

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**Not Shown**