

Abstract: Entertainment and recreation have always played an important role in business. And while the IRS and courts scrutinize tax deductions for these activities, they also recognize that businesspeople conduct legitimate business over lunch or on the golf course. The scrutiny isn't surprising. After all, entertainment is an area that's ripe for abuse. This article explains how following the rules and paying close attention to substantiation requirements will allow companies to successfully mix business and pleasure without giving up the tax benefits.

Take care when mixing business with pleasure

How to substantiate entertainment expenses

Entertainment and recreation have always played an important role in business. And while the IRS and courts pore over tax deductions for these activities, they also recognize that businesspeople conduct legitimate business over lunch or on the golf course.

The scrutiny isn't surprising. After all, entertainment is an area that's ripe for abuse. But if you follow the rules, you can successfully mix business and pleasure without giving up the tax benefits.

Supporting your entertainment expenses

Generally, your company can deduct "ordinary and necessary" business expenses. But the tax code imposes additional requirements on entertainment expenses.

To support an entertainment expense deduction, you must be able to show:

- The expense is directly related to or associated with the active conduct of your business — an expense may be "associated" with your company if the entertainment directly precedes or follows a "substantial and bona fide business discussion,"
- The deduction is adequately substantiated by records (or other evidence) that establish the amount, time, place and business purpose of the expense, as well as the business relationship of the parties involved,
- You had "more than a general expectation" of gaining a business benefit from the entertainment,
- You engaged in some business activity, other than the entertainment, such as a meeting, negotiation, discussion or other bona fide business transaction,
- The "principal character or aspect" of the combined business and entertainment was business, and
- The expense was attributable to you, your employees or others involved in conducting business.

Keep in mind, otherwise allowable deductions for meals and entertainment are generally reduced by 50%. (See the sidebar "In pursuit of a free lunch.")

Hunting — and fishing — for tax deductions

The case of *Townsend Industries Inc. v. United States* provides some important lessons for businesses deducting entertainment expenses. In this case, the Eighth U.S. Circuit Court of Appeals reversed a district court and held that the cost of a company's annual fishing trip was both deductible as a business expense and excludible from employee compensation as a working-condition fringe benefit.

Townsend was an Iowa-based manufacturer of printing equipment. Each summer the company gathered all its independent sales representatives for a two-day meeting at its headquarters. Following the meeting, Townsend sponsored a four-day, expense-paid fishing trip for its sales reps and factory employees at an upscale Ontario resort. Employees were encouraged, but not required, to attend. Although business discussions were conducted on an ongoing basis and one dinner meeting was held, workers were generally free to do as they pleased during the trip.

The IRS challenged Townsend's treatment of the trip expenses, contending they constituted wages that were subject to employment and income taxes. The district court agreed, finding: 1) the "fishing trips were not an ordinary and necessary business expense in light of the lax attendance policy for the trip," 2) there was "a disconnect between the sales meeting and the fishing trip," and 3) the company had no more than a general expectation to derive uncertain future benefits from the trips.

The court also found Townsend failed to meet substantiation requirements, citing the company's lack of contemporaneous, written records — details on why the expense is business related — and its reliance instead on employee testimony.

The Eighth Circuit disagreed, ruling that, despite the lack of contemporaneous records, trial testimony clearly established the fishing trips had a legitimate business purpose. Even though the trips were voluntary, employees "felt an obligation to attend, and some felt it was part of their job." Moreover, there was "extensive trial testimony" regarding specific business issues discussed and problems solved during the trips.

Although *Townsend* confirms the deductibility of travel and entertainment expenses that serve legitimate business purposes, the case also highlights the importance of substantiating these expenses with detailed, contemporaneous records. Even though the employer in *Townsend* ultimately prevailed without this information, the litigation cost was great.

Tax considerations not the only concern

In the current environment, companies also need to keep in mind that, even if an entertainment expense passes muster as a business deduction, it may not leave a good impression with others. While public companies may receive the greatest scrutiny, even private companies can harm their reputation in the community if it

appears they're spending excessive amounts on unnecessary entertainment, especially if it benefits only the owners or other top management.

So before incurring entertainment expenses, consider both their potential deductibility and whether they could have any other negative impact on your business. And if you determine an expense is worthwhile, be sure to substantiate it.

Sidebar: In pursuit of a free lunch

Businesses are generally limited to deducting 50% of otherwise allowable meal and entertainment (M&E) expenses, but there are several exceptions, such as expenses:

- Treated as compensation to employees,
- Excludible from employees' income as de minimis fringe benefits,
- Paid or incurred under a reimbursement or similar arrangement in connection with the performance of services, and
- For employee recreational or social activities — for example, picnics and holiday parties.

Unfortunately, separately identifying and reporting items that are 100% deductible can be complicated and time consuming. But if you spend a great deal on M&E expenses, it may pay to do so. Fortunately, the IRS now allows statistical sampling methods to be used to estimate the portion of M&E expenses that are fully deductible, which can ease the accounting burden.