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SUBSTANTIATION REQUIREMENTS

SUBSTANTIATION FOR DEDUCTION

In order to deduct expenses for auto, meals and lodging, entertainment, gifts, or expenses relating to listed property, §274(d) requires adequate records or sufficient evidence to corroborate:

1. the amount of the expense or mileage
2. the time and place of the travel, entertainment, or use of the property
3. the business purpose of the expense or mileage
4. the business relationship to the taxpayer of the persons entertained, the use of property, or the person receiving the gift. See Appendix A.

Additionally, expense for entertainment must meet either the "directly related" or "associated" tests.

1. **Directly related**: If the expenses take place in a clear business setting and are for your business, the expenses are considered directly related. Additionally, you should demonstrate that:

    - the main purpose of the combined business and entertainment was the active conduct of business
    - you did do business within that entertainment period
    - you had a good expectation of getting income or a business benefit at some future time

2. **Associated**: The entertainment must be associated with your trade or business and must directly precede or follow a substantive (active) business discussion. If you use the "associated" provision, you must be able to document and/or prove:

    - the date and duration of the business discussion
    - where the discussion took place
    - the nature of the discussion, and with whom
    - the business reason for the entertainment or the nature of the business benefit derived or expected to be derived as the result of the entertaining

Example: Bob, a high-powered corporate attorney, invites Mark, the president of a corporate client of Bob's, to a hockey match. They meet in the afternoon to go over a new contract Mark is considering, stop for a bite to eat, and go on the hockey match. Assuming all other documentation requirements are met, the tickets are deductible under the "associated" rule.

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WHAT ARE "ADEQUATE RECORDS"?

Proper and adequate records include:

1. Diary or daily log,
2. Statement of expense,
3. Canceled checks, receipts, or bills.

The records must include the amount, date, place, and essential character of the expense. Just stating whom you took to dinner is not adequate if you do not note the **reason** for the dinner.

Example: Bob takes Mark out for dinner to discuss a potential lawsuit against Mark's company. They travel in Bob's car (Bob dutifully noting the mileage from his office forward). He submits the following billing to his company the next day:

> Dinner with Corp. president, Mark 7/31/92, at La Boheme Restaurant.
> Receipt attached for $45.00.
> Also paid a tip of $9.00.

If you do not have adequate records to prove an element of expense, you must prove the element by your own statement, either written or oral, which contains specific information about the expense and any other supporting evidence to corroborate. For example, you could use written testimony from a guest.

What if you are entertaining a large group of people? If you have a class of "readily identifiable" individuals, you do not have to record each person's name. For example, you could state you took the "board of directors of YNOT Corporation" for snacks after meeting. You could not, however, state that you took "persons associated with YNOT" or "customers of YNOT", because these groups are not readily identifiable. You could state "Ken Mattel and his five salesperson staff of Happy Corp", since they can be readily identified if necessary.

These records should be made at or near the time the expense is made, although you don't need to keep a daily log. Estimates or approximations are not adequate and will not qualify as proof of an expense. Additionally, you have to be able to prove **each separate expenditure** for traveling away from home and for entertaining. You cannot aggregate the amounts and state a total expended for meals, etc. without proving each individually.

You must keep proof of these expenses to support the deduction for as long as your income tax return may be subject to examination. After the statute has closed you may discard the evidence. See Appendices B and C. The documentation may be maintained either by the employer who reimburses the employee for business expenses, or by the employee. At the commissioner's discretion, there are rules whereby the employer does not maintain the records, but the reimbursed employee maintains the records.

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WHAT ARE "ADEQUATE RECORDS"? (CORPORATE)

Example: Sandy receives a monthly auto allowance from her employer. The employer does not include this amount on her W-2 and asks Sandy to sign a statement that Sandy will keep her own records to document her business usage, take a 2106 deduction (Sch A) for any expenses in excess of reimbursement (subject to the 2% limitation), and include in income any excess reimbursement. Does the employer have to keep copies of any of Sandy's detailed records? No, not if the employer maintains "adequate accounting" procedures.

In the above example, if Sandy gets reimbursed mileage upon presenting it to her employer, does she need to keep a record of what she has submitted and been reimbursed for? What if she is a stockholder or related employee?

CLUB DUES - PRE 1994 ONLY

Expenses attributable to a social or exercise club used for entertaining are not deductible unless the club is used more than 50% in **furtherance of the taxpayer's trade or business**. The taxpayer needs to keep records of his use of the club, the cost of using it, etc. to establish greater than 50% usage. The dues are deductible to the extent you are able to document business purpose percentage, but only if used more than 50% for business purpose. Documentation for clubs would include the same documentation as above, i.e.: who, when, where, how much, and why. However, just because a club is composed of businesspersons such as Kiwanis, and the club has business speakers, this fact alone doesn't necessarily make the dues fully deductible. The dues for such clubs are subject to the same substantiation.

WHEN DON'T YOU NEED DOCUMENTARY EVIDENCE?

If you are traveling away from home on business, you may opt to deduct a standard amount for your daily meals, rather than keep records of the actual amounts. You must still keep records to prove the time, place and business purpose of your travel, but you don't need to keep meal receipts. (Note: This cannot be used by an employee related to his/her employer, or a more than 10% stockholder).

For most US locations the standard rate is $26 per day of travel. For less than 24 hours you must prorate the rate. For certain high-buck cities such as Los Angeles and New York you may live high on the hog with a $35 per day allowance.

If you are not reimbursed by your employer for meals, you can deduct only 80% of this standard meal allowance.

When you cannot get a receipt, other evidence may be allowed, **if**:

1. you were unable to obtain documentary evidence
2. you were unable to obtain either a statement or other supporting evidence, **and**
3. you have other evidence that is the best proof possible under the circumstances

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THE "COHAN RULE"

This rule applies when it is clear that the taxpayer incurred some expense. The court will make its own estimate of what the taxpayer spent for business purposes and allow a deduction accordingly. This rule generally **does not** apply to estimates of travel and entertainment under §274(d), but may apply to estimated amounts that are "incidental" in nature.

Incidental expenses include:

1. Tips at a restaurant or a taxi cab
2. Long distance calls at a pay phone
3. Bus fare

These expenses should be noted in a diary or log at the time of occurrence to insure deductibility.

EXPENSES EXEMPT FROM SUBSTANTIATION

The following business expenses are exempt from the detailed substantiation requirements and may be substantiated as any other business expense:

1. Recreational or social functions for employees: the holiday party, staff meeting luncheon.
2. Any goods or services furnished by the taxpayer to the employees reported as taxable income subject to withholding by the employee: holiday gifts of cash or large gift baskets.
3. Telephone expenses.
4. Laundry and cleaning (uniforms).
5. Expenditures under $25: a receipt or bill is not required, but time, place, business purposes, and business relationship are required.

DREADED DISALLOWANCE

What happens if the IRS decide not to allow a deduction for entertainment, auto expenses, etc.? Double taxation occurs. The expense is not allowable as a deduction at the business or corporate level. Additionally, the Feds will include the disallowed amount into the employee's income for the year paid. This is particularly true when the employee is a stockholder or other related party. The stockholder-employee may end up with a dividend. This can be avoided by using a binding obligation between the employee and the corporation, that obligates the employee to repay the corporation for any disallowed travel and entertainment expenses. The double tax can be avoided if the stockholder-employee can deduct (and offset) his repayment.

Disallowance may also result in a civil fraud penalty up to 50% on top of the double tax. This would be the case if the travel and entertainment couldn't properly be considered as corporate expenses.

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AUTO SUBSTANTIATION

The above rules for adequate substantiation applies to business use of auto as well. The employee must include as taxable income any personal use of employer owned vehicle. (See worksheet for calculation of income).