# PART VIII: BUSINESS EXPENSE DEDUCTIONS

## 8676. What is a business expense deduction?

A business expense deduction is a deduction allowed for ordinary and necessary expenses paid or incurred in connection with an individual's trade, business or profession.[1] The deduction allowed under IRC Section 62(a)(1) for expenses of a trade or business is the provision which technically allows for business income to be taxed on a net income basis, whether it be a corporate business or the business of individual taxpayers operating as sole proprietors or partners. In the case of a sole proprietorship or partnership, IRC Section 62(a)(1) operates to assure that all trade or business expenses, deductible as delineated under specific IRC Sections, are effectively allowed as above-the-line deductions, rather than itemized deductions. In the case of a sole proprietor, all but a few of these expenses are deducted in Schedule C of Form 1040.

For purposes of determining whether an expense may be deducted as a business expense, an expense is considered to be "ordinary" if it is one that is commonly incurred in the trade or occupation of the taxpayer. An expense is "necessary" if it is found to be appropriate or helpful to the taxpayer's business or occupation. Among the common expenses in this category are: employees' salaries; office rent; interest on business loans; the cost of supplies and utilities; traveling; entertainment; advertising; and automobile expenses.

Generally, business expenses of a self-employed individual (sole proprietor, independent contractor, or professional) may be deducted from gross income to arrive at adjusted gross income. The deductions are taken on Schedule C of Form 1040 in computing the net gain or loss from the taxpayer's business or profession.

The IRS has ruled that a full-time life insurance salesperson who is treated as a "statutory employee" for FICA purposes is *not* an "employee" for purposes of IRC Sections 62 and 67. Such individuals may thus treat unreimbursed business expenses as "above the line" deductions. This ruling was issued in part to clarify that taxpayers who are treated as "statutory employees" for FICA purposes (as are life insurance salespersons) are not necessarily treated as "employees" for other purposes.[2] The term "statutory employee" refers to certain individuals described in IRC Section 3121(d)(3)(B), who are subject to FICA withholding requirements (see Q 8661). The ruling's effect was essentially limited to those individuals.

See Q 8677 to Q 8692 for a detailed discussion of the various types of business expenses commonly deducted by taxpayers.

## 8677. Is a taxpayer entitled to deduct business travel expenses?

Generally, a taxpayer is entitled to deduct travel expenses when those expenses are incurred while the taxpayer is "away from home" for business reasons.[3] This is the case even though those travel expenses would otherwise be personal expenses (such as food or lodging). There are three

1. IRC Sec. 162(a).
2. Rev. Rul. 90-93, 1990-2 CB 33.
3. IRC Sec. 162(a)(2).

basic requirements that must be met before a taxpayer will be entitled to deduct business-related travel expenses:

(1) The expense must be a reasonable and necessary traveling expense;

(2) The expense must be incurred while "away from home;" and

(3) The expense must be incurred "in the pursuit of business."[1]

For an expense to be incurred in the pursuit of business, it must be directly connected to the trade or business of the taxpayer, and the expense must be necessary or appropriate to developing or pursuing the taxpayer's business or trade.[2]

Interpretation of the "away from home" requirement has been litigated extensively. Under the IRS interpretation, "away from home" for these purposes means that the taxpayer must be away from the taxpayer's principal place of business—not personal residence.[3] Several courts, however, have agreed with the contrasting opinion that the taxpayer's "home" is the taxpayer's residence.

**Planning Point:** If the taxpayer is engaged in business at two or more separate locations, the "tax home" for purposes of section 162(a)(2) is located at the principal place of business during the taxable year.[4]

See Q 8678 for a detailed discussion of the "away from home" requirement as it applies to taxpayers who travel frequently for business.

## 8678. When is a taxpayer considered to be "away from home" for purposes of deducting business travel expenses? What if the taxpayer is away from the taxpayer's residence for an extended period of time for business reasons?

As discussed in Q 8677, the IRS requires that a taxpayer be away from the company's principal place of business, rather than a residence, in order to deduct business travel expenses that would otherwise be personal in nature (such as food and lodging). The IRS has ruled that a taxpayer's tax "home"—meaning principal place of business—is not limited to a specific building or work-site, but instead encompasses the entire city or general area in which the business is located.[5]

In cases where a taxpayer is required to take extended business trips, determining the location of a taxpayer's primary place of business becomes difficult, though for most taxpayers, the determination is simple because many taxpayers maintain a residence in the general vicinity of their primary place of business. For taxpayers who are required to travel often for business, such extended business travel raises the question as to where that taxpayer's tax "home" is located.

1. *Commissioner v. Flowers*, 326 U.S. 465 (1946), *Robertson v. Commissioner*, 190 F.3d 392 (1999).
2. Rev. Rul. 54-147, 1954-1 CB 51.
3. See Rev. Rul. 75-432, 1975-2 CB 60.
4. *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974), Rev. Rul. 60-189, 1960-1 CB 60.
5. Rev. Rul. 56-49, 1956-1 CB 152.

Generally, in order for the taxpayer to deduct business-related travel expenses, the travel must be temporary in nature ("temporary" for these purposes has been statutorily interpreted to mean an employment period not exceeding one year[1]).

In other words, if a taxpayer is assigned to a new work location for an *indefinite* period of time, the taxpayer's principal place of business—and tax "home" for travel expense deduction purposes—is transferred to that new location.[2]

Often, the analysis of whether a taxpayer who travels for business has acquired a second "tax home" turns upon whether or not it would be reasonable to expect that taxpayer to relocate. For example, the Second Circuit has held that the real issue in a case where the taxpayer resided in Colorado, but had committed to a two year position in New York, was whether or not a reasonable person in her position would have relocated her residence to New York.[3]

Congress has clarified the issue so that Section 162 now specifically provides that a taxpayer will *not* be temporarily "away from home" for any period of employment that exceeds one year for tax years beginning after 1992.[4] If the taxpayer can show that the business travel was realistically expected to last for one year or less, and that travel in fact does last for one year or less, the travel will be considered temporary. On the other hand, if the travel is realistically expected to last for more than one year, or there is no realistic expectation that the travel will last for *less* than one year, the travel will be considered indefinite *regardless of whether it actually lasts for more than one year*.[5] A very narrow exception to this rule exists for federal employees who are travelling in connection with the investigation or prosecution of a federal crime.[6]

This statutory rule applies for taxpayers travelling for business reasons to a *single location* for more than one year. The distinction between indefinite and temporary business travel remains important in situations where the taxpayer's business travel may include *multiple* travel locations over a period that exceeds one year.

In *Wilson v. Commissioner*, for example, the taxpayer, who was from Idaho, was assigned by his employer to a series of temporary construction jobs in various locations in California over a period of time that exceeded one year. He claimed that, because each of these jobs was temporary, his principal place of business was in Idaho so that he should have been entitled to deduct his travel expenses while working in California. The Tax Court disagreed, finding that, while construction jobs are temporary by nature, all of the facts and circumstances had to be examined to determine whether the business travel was in fact indefinite. In this case, the overarching employment relationship was important and demonstrated an indefinite relationship so that the taxpayer could not reasonably argue that his travel could be segmented into individual construction jobs.[7]

1. Chief Counsel Memo 106447-98 (08-06-1998), Energy Policy Act of 1992 (1938), Pub. L. No. 102-486.
2. See *Peurifoy v. Commissioner*, 358 U.S. 59 (1958).
3. *Six v. United States*, 450 F.2d 66 (1971).
4. IRC Sec. 162(a) (flush language).
5. Rev. Rul. 93-86, 1993-2 CB 71.
6. IRC Sec. 162(a) (flush language).
7. *Wilson v. Commissioner*, TC Memo 2001-301.

## 8679. Can a taxpayer deduct business travel expenses if the taxpayer travels so frequently that it is found that the taxpayer has no "tax home" for determining whether the "away from home" requirement of Section 162 is met?

Yes. If a taxpayer travels constantly for business, it is possible that the taxpayer has no tax home for purposes of determining the deductibility of business travel expenses under Section 162.

For example, in *McNeill v. Commissioner*, the taxpayer was a truck driver who was travelling so frequently that the Tax Court found he had no principal place of business. Further, no significant expenses were incurred in connection with maintaining a principal residence, as he paid approximately $1,000 a year for a mobile home until he owned it in full and, for the tax years in question, the taxpayer only spent approximately 20 days per year in the mobile home. Though the taxpayer attempted to deduct all travel and meal expenses while he was "on the road," the Tax Court denied the deductions, finding that, in a case like this, the taxpayer was *never* "away from home" for tax purposes and, therefore, was not entitled to deduct any business travel expenses.[1]

Similarly, in *James v. United States*, the taxpayer was a travelling salesperson who spent so much time in travel that the Ninth Circuit found there were insufficient contacts with any location to determine a tax home. In this case, the court discussed whether a taxpayer was required to maintain a physical residence in order to *ever* be considered "away from home" for purposes of Section 162. Because the intent of Congress in allowing the deduction was to prevent the taxpayer from incurring duplicate (lodging) or higher (meal and lodging expenses tend to be higher in travel) expenses during business travel, the court found that the deduction should only apply in cases where the taxpayer has a "home" and must expend funds to maintain this home. Further, if a taxpayer has no permanent home, and must therefore obtain food and shelter in public restaurants and hotels whether or not the taxpayer is traveling, there is no justification for allowing the deduction for business travel expenses.[2]

Therefore, in rare cases, it is possible that the taxpayer will never be allowed to deduct business travel expenses whether or not they are incurred in the pursuit of a trade or business, because the taxpayer will never actually be "away from home." In other words, if a taxpayer is constantly on the move due to his work, he is never "away" from home.[3]

## 8680. Are business-related travel expenses deductible if a taxpayer resides in a location that is far from the taxpayer's principal place of business?

A taxpayer is entitled to deduct business travel expenses, but is not entitled to deduct the costs incurred in *commuting* between the taxpayer's principal residence and place of business.[4]

When a taxpayer chooses to reside in a location that is far from the taxpayer's principal place of business, the issue is not whether the taxpayer is "away from home" when travelling

1. TC Memo 2003-65.
2. *James v. United States*, 308 F.2d 204 (1962).
3. *Deamer v. Commissioner*, 752 F. 2d 337. 338 (8th Circuit 1985), affg. T.C. Memo 1984-63.
4. See, for example, *United States v. Tauferner*, 407 F.2d 243 (1969); *Sanders v. Commissioner*, 439 F.2d 296 (1971).

between a residence and place of business, but whether or not the travel expenses are sufficiently connected to a trade or business as to be deductible under Section 162.

For example, the Tax Court has denied the taxpayer's travel expense deductions in a situation where the taxpayer maintained a residence in Tennessee with the taxpayer's family. The taxpayer was unable to find employment in Tennessee and accepted employment in North Carolina. The family continued to reside in Tennessee and the taxpayer incurred duplicate living expenses as a result, which he attempted to deduct as business travel expenses. The Tax Court denied the deductions, finding that the taxpayer's choice in maintaining his personal residence far from his principal place of business was not a business expense that was reasonable and necessarily connected to his business. Rather, these duplicate living expenses were the result of the taxpayer's personal choice to maintain a residence in Tennessee.[1]

Similarly, a postal employee who lived and worked in New York, but was promoted to a position (national president of the post office) that required him to spend approximately 300 hours per year in Washington, D.C., was unable to deduct his travel expenses between New York and Washington D.C. The taxpayer's wife continued to live in their New York residence and the taxpayer stayed in hotels and took his meals there while in Washington D.C. Even though the position required that the taxpayer spend significant time in Washington D.C., it did not require that he continue to maintain a residence in New York. Because of this, the expenses that he incurred while residing in Washington D.C. were found to be personal living expenses, rather than business travel expenses.[2]

## 8681. Is a taxpayer entitled to a deduction for travel expenses when the taxpayer has multiple places of business?

If a taxpayer regularly conducts business in more than one location, a determination must be made as to which location is the "principal" place of business. This determination must be made by examining all the facts and circumstances of the particular case, but the IRS has identified the following factors as important:

(1) The total time spent at each of the business locations;

(2) The degree of business activities at each location; and

(3) Whether the financial return in each location is significant or insignificant.[3]

Though all three factors are important, the IRS generally considers the amount of time spent at each location to be the most important factor.[4]

For example, the Tax Court has held that a taxpayer who maintained a business in New York and another in Massachusetts was entitled to deduct expenses while travelling in

1. *Tucker v. Commissioner*, 55 TC 783 (1971).
2. *McAvoy v. Commissioner*, TC Memo 1965-289.
3. Rev. Rul. 54-147, 1954-1 CB 51.
4. See Rev. Rul. 63-82, 1963-1 CB 33, Rev. Rul. 61-67, 1961-1 CB 25.

NewYork because the taxpayer spent more of his time in Massachusetts.[1] In situations where the taxpayer's time is relatively evenly divided, all of the facts and circumstances will be analyzed to determine which place of business constitutes the taxpayer's "principal" place of business.[2]

Once the taxpayer's principal place of business is determined, the general rules applicable in determining whether travel expenses are deductible are applied. Thus, a taxpayer can deduct expenses for meals and lodging while conducting business in a secondary business location if an overnight trip is required. Transportation expenses can be deducted between the principal and secondary places of business even if an overnight stay is not required.[3] Expenses incurred while the taxpayer is in the vicinity of his principal place of business are not deductible.

## 8682. Can a taxpayer deduct travel expenses for a trip that has both business and personal elements?

The deduction for otherwise personal expenses incurred while a taxpayer is away from home for business purposes is only allowed to the extent that the travel is reasonable and necessary for a taxpayer's trade or business. However, because there have been many instances where a taxpayer attempts to deduct expenses for what essentially constitutes a personal vacation, the IRS has developed rules that govern a trip that combines both business and personal elements.

If the primary purpose behind a taxpayer's trip is personal, no travel expense deductions for expenses incurred in traveling to and from the destination will be permitted even if the taxpayer does, in fact, engage in some business activities during the course of the trip. However, if a trip has both business and personal elements, the taxpayer may deduct those expenses that are properly allocated to the business portion of the trip even if unable to deduct the expense of traveling to and from the destination because it is found that the trip was primarily undertaken for personal reasons.[4]

Whether a trip is primarily business-related or primarily personal is a question of fact. Though all facts and circumstances must be considered, the IRS has provided that an important factor is the amount of time spent on business compared to the amount of time spent on the taxpayer's personal activities.

**Planning Point:** If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.[5]

Travel expenses for the taxpayer's spouse (or other family member) to accompany the taxpayer on a business-related trip are not deductible unless the taxpayer is able to show that there

1. *Sherman v. Commissioner*, 16 TC 332 (1951).
2. See, for example, *Bernard v. United States*, 87-1 USTC 1092 (1971).
3. Rev. Rul. 63-82, above.
4. Treas. Reg. §1.162-2(b)(1).
5. Treas. Reg. §1.162-2(b)(2).

is a bona fide business purpose for the spouse or family member's presence. This is the case even if it is found that the taxpayer's trip is primarily business-related.[1]

Similar rules apply in the case of a taxpayer's travel expenses related to attendance at a convention—meaning that the expenses are not deductible if the reason for attending is not sufficiently related to the taxpayer's trade or business. However, the rules make clear that the fact that the taxpayer's attendance is voluntary will not impede the taxpayer's ability to deduct related travel expenses—even if the taxpayer actually uses vacation days in order to attend—so long as attendance at the convention is motivated by business reasons.[2]

## 8683. Do any special rules apply for a taxpayer who wishes to deduct business-related travel expenses for travel that takes place outside the United States?

Yes. IRC Section 274 applies to reduce the amount of otherwise allowable business travel deductions for taxpayers travelling for business outside of the United States unless one of the following are true:

(1) the trip has a duration of one week or less, or

(2) less than 25 percent of the trip is spent pursuing personal, nonbusiness activities.[3]

"One week" for this purpose means seven consecutive days, *not* including the day that travel begins but including the day that the taxpayer travels home.[4]

Unless the taxpayer establishes a more clear method of allocation that satisfies the IRS, whether or not the taxpayer spends less than 25 percent of the trip on personal activities must be determined on a per-day basis, meaning that each day will be considered a "business day" or a "nonbusiness day."[5]

"Transportation days," meaning days during which the taxpayer was engaged in travelling from the U.S. to a foreign destination in pursuit of business, are counted as business days unless the taxpayer does not take a reasonably direct route. If the taxpayer takes an indirect route for nonbusiness purposes, only the amount of time that would have been spent to travel by direct route using the same type of transportation will be considered business days.[6]

If the taxpayer is specifically required to be in the foreign location for a business purpose for the day in question (for example, to attend a business meeting), that day will be counted as a business day.[7] Further, if the taxpayer was primarily engaged in business activities during normal working hours, that day will be counted as a business day.[8] An intervening weekend

1. Treas. Reg. §1.162-2(c).
2. Treas. Reg. §1.162-2(d).
3. IRC Sec. 274(c).
4. Treas. Reg. §1.274-4(c).
5. Treas. Reg. §1.274-4(d)(2).
6. Treas. Reg. §1.274-4(d)(2)(i).
7. Treas. Reg. §1.274-4(d)(2)(ii).
8. Treas. Reg. §1.274-4(d)(2)(iii).

day or holiday can be counted as a business day even if no business was conducted on that day (see example 3, below).

*Example 1*: Mel leaves for a foreign business trip on Wednesday and returns the following Wednesday. She is considered to have been away from home for seven days. Because she has not been away from home for more than one week, the special rules applicable to foreign travel do not apply.

*Example 2*: Same facts as above, except Mel returns on the following Thursday. She is considered to have been away from home for eight days, so must allocate her travel expenses between business and personal expenses to determine the percent of time spent on personal activities. The day spent travelling on Wednesday will be counted as either a business or nonbusiness day in determining whether Mel meets the 25 percent test.

*Example 3*: Mel leaves for Paris on a Wednesday and returns the following Sunday. Mel attends business meetings on Thursday and Friday, and the following Monday through Friday, when her business concludes. The first weekend will be counted as business days even if no business is conducted because they are "intervening"—her business had not yet concluded at the beginning of the weekend. Her second Saturday in Paris will be counted as a personal day because her business had concluded the day before.

If Section 274 applies, the taxpayer's travel expense deduction will be disallowed to the extent of nonbusiness travel. The taxpayer will be required to multiply the total amount of travel expenses by a fraction, the numerator of which is the number of nonbusiness days occurring during the trip, and the denominator of which is the total number of days (business and nonbusiness) spent on the trip.[1]

Taxpayers who have no substantial control over arranging the business trip, such as in a case where the employer arranges a trip for an employee, may allocate all expenses of the trip to business travel (control over only the timing of the trip is not considered substantial control). Likewise, anyone traveling on an employer's behalf under a reimbursement or other expense allowance arrangement is considered not to have substantial control over arranging the trip provided the individual is neither a managing executive of the employer with authority to decide on the trip's business necessity, nor related to the employer within the meaning of IRC Section 267(b) (i.e., family members, an individual and his or her more-than-50 percent owned corporation, two corporate controlled-group members).[2]

## 8684. Can a taxpayer deduct business-related transportation expenses incurred when the taxpayer is not travelling away from home on business?

A taxpayer who is not considered to be "away from home" for purposes of deducting business-related travel expenses (see Q 8677 to Q 8683) may still be entitled to claim a deduction for business-related transportation expenses. A taxpayer is generally *not* entitled to deduct the cost of commuting from the taxpayer's residence to the taxpayer's primary place of business. However, business-related transportation costs other than commuting costs may be deducted as business expenses. Examples of such expenses include the following:

(1) Travelling from one business place to another business place within the general area that is considered a taxpayer's "tax home" (see Q 8678 and Q 8679);

(2) Visiting clients and customers;

1. Treas. Reg. §1.274-4(f)(1).
2. Treas. Reg. §1.274-4(f)(5)(i).

(3) Travelling to a business meeting outside of the taxpayer's principal place of business;

(4) Travel from the taxpayer's residence to a *temporary* workplace if the taxpayer has one or more *regular* workplaces. A work location is considered temporary if it is realistically expected to last (and does last) for one year or less, unless the circumstances indicate otherwise.[1]

If a taxpayer's residence is also the taxpayer's principal place of business, that taxpayer may deduct the costs of commuting between the residence and another place of business, whether or not that second place of business is considered "regular" or "temporary."[2]

*Example*: Brent is a representative for a cheese manufacturing company and works out of his home. He has no permanent office, but regularly must drive to visit clients who have questions about his company's cheese products. Brent may deduct the cost of driving between his home and client sites, even though these visits occur on a regular basis. If Brent were required to travel outside of his regular area of business on an overnight trip, those costs would be deductible as travel expenses, *not* transportation expenses. Because Brent travels by car, he can either deduct the actual costs of his car *or* the standard mileage rate for the year (56 cents per mile in 2014).[3]

As stated above, expenses incurred for commuting from the taxpayer's residence to place of business are generally nondeductible. This is the case even though the taxpayer works during the commute—for example, by taking work-related calls or discussing business while carpooling with a business associate

## 8685. When is a taxpayer entitled to deduct moving expenses?

If certain conditions are met, a taxpayer may deduct reasonable moving expenses incurred in connection with beginning work at a new principal place of business, whether as an employee or self-employed person.[4] The following general requirements apply:

(1) The taxpayer must have incurred moving expenses;

(2) Those moving expenses must be related to the taxpayer's start of work at a new principal place of work;

(3) The taxpayer's new principal place of work must be at least 50 miles further from his principal residence than his former principal place of work *or*, if the taxpayer had no former principal place of work, at least 50 miles from his former residence;[5] and

(4) The taxpayer must work in the general location of the new principal place of work for a specified period. Specifically, this means that the taxpayer is either:

a. a full-time employee in the general location of the new principal place of work for at least 39 weeks during the 12-month period following his or her arrival *or*,

1. See IRS Publication 463, available at http://www.irs.gov/publications/p463/ch04.html (last accessed June 2, 2014).
2. IRS Pub. 463.
3. IR-2013-95 (Dec. 6, 2013).
4. IRC Sec. 217(a).
5. IRC Sec. 217(c)(1).

b. in the 24-month period following arrival, a full-time employee or self-employed individual (on a full-time basis) in the general location of the new principal place of work during at least 78 weeks (39 weeks must be in the first 12-month period). See Q 8661 and Q 8662 for a discussion of when a taxpayer is considered to be self-employed.[1]

For moving expenses that meet the requirements above to be "qualified," and thus deductible, they must relate to the expenses described below (the distinction also becomes important for determining whether the employee must include the costs of any employer-reimbursement in gross income, see Q 8686). "Qualified moving expenses" are:

(1) the costs incurred to move the taxpayer's household items from the first location to the second location; and

(2) the travel expenses (excluding meals, but including lodging) incurred by the taxpayer in travelling from the first location to the second location.[2]

The expenses described in (1), above, may include costs such as those related to packing, disconnecting and connecting utilities, and in-transit storage and insurance if incurred in the 30 day period after moving the goods from the taxpayer's former residence. The IRS specifically excludes costs such as losses sustained upon ending membership in clubs, wasted tuition fees, costs incurred in buying property or losses sustained upon selling property because of the move.[3]

Travel expenses described in (2), above, must be reasonable based on the facts and circumstances of the particular situation. Though the route travelled must usually be the shortest and most direct route, the taxpayer does not lose the deduction if the taxpayer incurs expenses that increase the cost of the move and are personal in nature. Instead, the deduction is reduced by the additional costs incurred for personal reasons.[4] The deduction is further reduced by any expenses deemed to be lavish or extravagant under the circumstances.

*Example*: Jeff is moving from Michigan to California for business reasons. He intends to drive but, rather than directly making the trip, he decides to stop and visit friends in St. Louis and Las Vegas along the way. Jeff is entitled to deduct the cost of moving from Michigan to California, minus any additional costs he incurs while visiting friends in other cities for personal reasons.

**Planning Point:** Travel expenses from the former to the new residence are deductible for one trip only. The trip must be made by the taxpayer and members of the taxpayer's household. It is not necessary, however, that the taxpayer and all household members travel together or at the same time.[5] The cost of traveling from a former home to a new one should be by the shortest, most direct route available using conventional transportation.[6]

1. IRC Sec. 217(c)(2).
2. IRC Sec. 217(b)(1).
3. Treas. Reg. §1.217-2(b)(3).
4. Treas. Reg. §1.217-2(b)(2).
5. Treas. Reg. §1.217-2(b)(4).
6. IRS Pub 521, Moving Expenses (2013).

A taxpayer is also entitled to deduct the moving expenses of other members of his household, provided that the household member's principal place of residence was both at the first location and at the second location.[1]

Generally, moving expenses are treated as an "above the line" deduction; thus, if allowable, such expenses are deductible directly from gross income.[2]

## 8686. Can an employer deduct moving expenses for which it reimburses its employees? Are reimbursed moving expenses included in the taxpayer-employee's gross income?

Generally, if an employer reimburses an employee for business-related moving expenses (see Q 8685), that employer is entitled to deduct the reimbursed amount as an ordinary and necessary business expense under IRC Section 162.

If a taxpayer is reimbursed by the employer for non-qualified moving expenses (see Q 8685), the taxpayer must include those reimbursed amounts in gross income as compensation for services rendered.[3] A taxpayer is not required, however, to include amounts reimbursed for "qualified moving expenses" in gross income (see Q 8685). These qualified moving expenses are instead treated as a fringe benefit that is specifically excluded from an employee's income.[4]

In order for a moving expense reimbursement to be excludable from the employee's gross income, the reimbursement must be related to an expense that would be deductible by the employee (if the employee had paid it directly, see Q 8685) under IRC Section 217. If the employee actually did deduct the expense in a prior year, reimbursement for the expense is not excludable under Section 132.[5]

## 8687. Is a taxpayer entitled to claim a deduction for business-related education expenses?

An employee is generally entitled to deduct education-related expenses that meet the following requirements:

(1) The expense must relate to education that is designed to maintain or improve skills used by the taxpayer in his or her trade or business; or

(2) The education must be specifically required by the employer, or under applicable law or regulations, in order for the taxpayer to retain an established employment relationship, status or compensation level.[6]

1. IRC Sec. 217(b)(2). See also, *Shah v. United States*, 450 F. Supp. 1136 (1978).
2. IRC Sec. 62(a)(15).
3. IRC Sec. 82.
4. IRC Sec. 132(a)(6).
5. IRC Sec. 132(g).
6. Treas. Reg. §1.162-5(a).

Despite this, there are circumstances under which a taxpayer's educational expense deduction will not be permitted even if the qualifications described in (1) and (2) above are satisfied. Educational expenses will be considered personal, nondeductible expenses if:

(1) The expense is incurred in obtaining the minimum educational requirements for qualification in the taxpayer's business (for example, obtaining a law degree) though, once the employee has met the minimum educational standards upon entering his trade or business, he will be treated as continuing to meet those standards even if they are eventually changed;

*Example*: New Jersey requires all secondary school teachers to have a bachelor's degree that includes 30 credit hours of professional education courses. In New Jersey, if a school can certify that a qualified secondary school teacher with the requisite degree cannot be found, that school is permitted to hire a secondary school teacher who has completed at least 90 semester hours of college-level work, though such an individual is required to complete his or her degree within 3 years of hire to retain the position.

Annelise begins teaching in New Jersey with a bachelor's degree and 30 credit hours in professional education. Two years later, New Jersey adds the requirement that a secondary school teacher must complete a fifth year of education within 10 years of beginning his or her employment to maintain certification. Annelise completes her fifth year of education three years later and obtains the required certificate. The fifth year of education is not part of the minimum educational requirements for secondary school teachers, so Annelise is entitled to deduct her expenses in obtaining the certificate.

*Example*: Same facts as above, except Annelise is hired during a period where there is a shortage of teachers and she has not yet completed her bachelor's degree. She completes her bachelor's degree within her first two years of employment. The expenses are not deductible, because a bachelor's degree is one of the minimum qualification requirements for secondary school teachers in New Jersey.[1]

(2) The expense is incurred in obtaining education that will qualify the taxpayer for entering a new trade or business. A "change of duties" does not constitute a new trade or business if the new duties involve the same general type of work involved in the taxpayer's present employment. For this purpose, all teaching and related duties are considered to involve the same general type of work.[2]

*Example*: Annelise is an elementary school teacher and, during the course of her employment, takes the classes necessary to qualify as a secondary school teacher. The educational expenses are deductible because they do not qualify Annelise for entering a new trade or business. Her husband, Kevin, is self-employed as an accountant and taking law school courses in the evenings. Kevin's education expenses are nondeductible, because they qualify him for entering a new trade or business.

## 8688. What special rules apply when a taxpayer deducts business-related entertainment expenses and meals?

Special restrictions apply when a taxpayer deducts business meal and entertainment expenses. A taxpayer is generally entitled to deduct the cost of a business meal if (a) the meal is not lavish or extravagant and (b) the taxpayer (or employee of the taxpayer) is present at the meal.[3]

1. Treas. Reg. §1.162-5(b)(2)(iii), Ex. 1.
2. Treas. Reg. §1.162-5(b)(3)(i).
3. IRC Sec. 274(k).

Entertainment expenses are typically only deductible if the taxpayer establishes that the activity is directly related to or associated with the taxpayer's trade or business.[1]

Generally, the deduction for the ordinary and necessary cost of business meals (i.e., those expenses which are not lavish and extravagant), are reduced by half, so that only 50 percent of allowable costs are deductible.[2] For certain taxpayers who are employed in the transportation industry, and are frequently required to have meals away from home (such as flight crews, interstate truck drivers, etc.), 80 percent of the cost of business meals is deductible for tax years beginning after 2007.[3]

In order to deduct the cost of business-related meals, taxpayers must also establish that the meal was either "directly related" or "associated with" the taxpayer's business (i.e., the taxpayer must show that the expense was incurred directly before, during, or after a bona fide business discussion) in order to deduct the cost.[4]

The deduction for business entertainment expenses is also generally limited to 50 percent of otherwise allowable costs.[5]

If the amount of the allowable deduction is reduced because the expense is found to be lavish or extravagant, the 50 percent limitation is applied *after* the cost has been reduced by the portion that is deemed to be unacceptable.[6]

If an employee is fully reimbursed for the expense of business meals and entertainment, such expenses are fully deductible by the employer, although the 50 percent limitation will apply to the employer's deduction.[7] However, if the expenses are not reimbursed, the employee is subject to the 50 percent limitation described above. Furthermore, the unreimbursed expenses that are deductible after that limitation are then subject to the 2 percent floor on miscellaneous itemized deductions.[8]

## 8689. When is a business-related entertainment or meal expense "ordinary and necessary" so that it may be deducted?

Whether a business-related entertainment or meal expense is ordinary and necessary is generally a question of fact. The courts have recognized that the taxpayer is entitled to exercise a certain degree of discretion in determining whether an expense is ordinary and necessary in the taxpayer's particular business.[9]

1. IRC Sec. 274(a).
2. IRC Sec. 274(n).
3. IRC Sec. 274(n)(3).
4. IRC Sec. 274(a)(1)(A).
5. IRC Sec. 274(n).
6. H.R. Rep. No. 841, 99th Cong., 2d Session at II-25 (1986).
7. IRC Sec. 274(n)(2)(A).
8. IRC Secs. 274(n)(1), 67(b).
9. *Cravens v. Commissioner*., 272 F.2d 895 (1959).

Expenditures are generally found to be sufficiently necessary if, based on all the facts and circumstances, they are "appropriate and helpful" to the taxpayer's business.[1] Expenditures are generally found to be sufficiently ordinary if they are made for "sound and normal" business expenses of a nature and amount determined by general commercial standards.[2]

The Tax Court has allowed a deduction for entertainment expenses incurred by a bank that paid for private dinner parties at a country club (hosted by the bank's officers) for its significant customers ("key people" from among the bank's top five hundred clients and prospective clients in the upper echelon of the financial community)[3] The court noted that, in this case, there was evidence that these customers were not being reached by more direct methods, so it was not unreasonable for the bank to resort to private entertainment in order to entice their business.

On the other hand, when a public defender who supervised several attorneys attempted to deduct the cost of taking those attorneys to lunches at the public defender's country club, the Tax Court denied the deduction on the grounds that such expenses were not ordinary and necessary for a taxpayer who is engaged in the business of being a public defender. This was the case even though the court recognized that the lunches tended to boost morale and encourage efficient work. Also important was the Tax Court's recognition that these expenses might have been found to be ordinary and necessary were they incurred by a partner operating in a private law firm.[4]

## 8690. What limitations apply to prevent a taxpayer from deducting lavish or extravagant business-related entertainment expenses?

The prohibition on the deductibility of lavish or extravagant business-related expenses is tied to the notion that the expense must be reasonable in order to be deducted—a determination that is made based on the facts and circumstances of each individual case. Based on this premise, the courts have allowed taxpayers to deduct expenses that might be considered unreasonable in other contexts.

For example, the Tax Court has upheld a taxpayer's deduction for expenses incurred in using a chauffeured Cadillac to provide local transportation for securities analysts and investment advisors in New York.[5]

Conversely, the Tax Court has disallowed deductions for lease payments made on a Rolls Royce by a plastic surgeon. The court's opinion reflects the importance of whether the expense is reasonable, rather than the level of extravagance displayed. In this case, the taxpayer-surgeon claimed that the Rolls Royce was used in advertising and promoting the quality of his services, and that he only used the car for business travel between the hospital and medical conventions. The Tax Court rejected the petitioner's argument that the Rolls Royce would attract customers,

1. *First National Bank v. United States*, 276 F. Supp. 905 (1967).
2. *Byers v. Commissioner*, 199 F.2d 273 (1952).
3. See *First National Bank*, above.
4. *Wells v. Commissioner*, TC Memo 1977-419.
5. See *Denison v. Commissioner*, TC Memo 1977-430.

finding that it had no reasonable relationship to his skill and performance as a plastic surgeon and that there was no evidence that any patients were attracted based on the leasing of the car.[1]

## 8691. What substantiation requirements apply when a taxpayer deducts business-related entertainment and meal expenses?

In order for a taxpayer to deduct business-related entertainment and meal expenses, the taxpayer must maintain records adequate to provide the following information:

(1) The amount of each separate entertainment (or meal) expense;

(2) The time and date upon which the expense was incurred;

(3) The name, address and/or location where the expense was incurred (if the location information does not make the type of entertainment apparent, the taxpayer must indicate whether it was a dinner, theater, sporting event, etc.);

(4) The business reason for the entertainment or the business benefit expected to be derived from the event, and (except in the case of business meals furnished on employer premises), the nature of any business discussion or activity;[2]

(5) A description of the business relationship between the taxpayer and the parties who were entertained (name, title or other description sufficient to establish the business relationship).[3]

The taxpayer's records must contain all of the above information or the deduction may be disallowed.[4] However, if the taxpayer entertains a large group of individuals, the taxpayer is not required to provide a name, title and description for each individual—a general description, such as "directors of Company X," will suffice if the group is homogeneous enough so that such a description will provide adequate identification. If, however, the taxpayer entertains a group that is so diverse that such a label will not identify the business relationship at issue, the IRS will require a listing on an individual basis.[5]

If a taxpayer holds season tickets for purposes of business entertaining, the event represented by each individual ticket must be treated as a separate entertainment event. For example, a taxpayer who holds season tickets for Boston Red Sox home baseball games must keep records providing the above information as it applies to each individual game.[6]

1. *Connelly v. Commissioner*, TC Memo 1994-436.
2. IRC Sec. 274(e).
3. Treas. Reg. §1.274-5T(b)(3).
4. See, for example, *Newman v. Commissioner*, TC Memo 1982-61 (deduction disallowed for insufficient substantiation because taxpayer failed to include location and business purpose information).
5. Rev. Proc. 63-4, 1963-1 CB 474.
6. Rev. Proc. 63-4, above, Q&A 17.

## 8692. When is a taxpayer entitled to deduct expenses incurred in maintaining a home office?

A taxpayer is only entitled to deduct expenses for a home office if the taxpayer is able to meet the restrictive requirements imposed by the IRC and the courts with regard to this business deduction. A deduction for use of a part of the taxpayer's residence as an office will not be allowed unless a portion of the dwelling is used exclusively and on a regular basis as (a) the principal place of business for any trade or business of the taxpayer; or (b) the place of business used by the taxpayer for meeting patients, clients or customers in the normal course of the taxpayer's business.[1] If the taxpayer uses a separate structure as a home office, the use requirements are less restrictive and the use must only be "in connection with" the taxpayer's trade or business.[2] A home office will qualify as a taxpayer's principal place of business if both of the following are true:

(1) The taxpayer uses the home office exclusively and regularly for administrative or management activities of the trade or business; and

(2) The taxpayer has no other fixed location for conducting substantial administrative or management activities of the trade or business.[3]

That a taxpayer chooses to have a third party perform administrative or management activities (such as billing) for the taxpayer will not, in itself, cause a disallowance of the deduction.

*Example*: Josh is an electrician who is self-employed. Most of his time is spent on-site with customers examining and repairing their electrical systems, but he maintains a small office in his home that is used exclusively and regularly for activities such as ordering supplies, calling his customers and keeping his books. Josh writes up estimates and records of work completed on-site at his customers' premises. He has engaged a local bookkeeping service for billing his customers, but he does not conduct any other substantial administrative or management activities outside of his home office. His home office will qualify for a home office deduction.

**Planning Point:** If the taxpayer is an employee and uses part of the taxpayer's home for business, the taxpayer must be able to show that, in addition to the requirements discussed above (1) the use is for the convenience of the employer and (2) no part of the home is rented to the employer and used to perform services as an employee for that employer.[4]

If the home office is merely appropriate and helpful, the deduction for home office expenses will be disallowed.[5]

For tax years beginning on or after January 1, 2013, the IRS has authorized an optional safe harbor method for calculating the amount of a taxpayer's home office deduction. The taxpayer calculates the home office deduction by multiplying the square footage of the home used for business purposes by a prescribed rate of $5.00. Under this safe harbor, the maximum allowable portion of a home that may be used for qualified business purposes is 300 square feet, which results in a maximum allowable home office deduction of $1,500.[6]

1. IRC Sec. 280A(c)(1).
2. IRC Sec. 280A(c)(1)(C).
3. IRS Publication 587, available at http://www.irs.gov/pub/irs-pdf/p587.pdf (last accessed July 18, 2013).
4. IRS Pub. 587, Business Use of Your Home (2012).
5. IRS Pub. 587, above.
6. Rev. Proc. 2013-13, 2013-6 IRB 478.

## 8693. How does an employer's reimbursement or failure to reimburse an employee's expenses impact a taxpayer's business expense deductions?

The tax treatment of an employee's business expenses depends on whether the employee is reimbursed for them by the employer. The IRC provides that expenses paid or incurred by the taxpayer, in connection with the performance of services as an employee, under a reimbursement or other expense allowance arrangement with the employer are deductible in full from gross income, to arrive at adjusted gross income, so long as the expenses otherwise qualify as business expense deductions.[1] Generally, this deduction will be available only to the extent that the reimbursement is includable in the employee's gross income.[2]

Employers are generally required to report certain employee reimbursements for business expenses on Form W-2. The reporting requirements apply to the following groups:

(1) employers who do not require substantiation (or whose employees fail to substantiate expenses);

(2) employers who advance amounts for expenses and do not require the return of (or do not receive) unused amounts; and

(3) employers who reimburse a per diem or other fixed amount that exceeds government specified rates.

The rules, thus, generally apply only to reimbursements for unsubstantiated expenses and unreturned excess amounts.[3]

It is not uncommon for an employee to incur expenses in connection with work that are not reimbursed by the employer. Examples include an employee's use of his own automobile or subscriptions to work-related professional journals. In general, the same business expenses that are deductible by a self-employed person are deductible if incurred by an employee, but in the case of an employee, the deduction is allowable only as an itemized deduction. As such, it is treated as a so-called "miscellaneous itemized deduction."[4]

Miscellaneous itemized deductions are allowed only to the extent that the aggregate of such deductions exceeds 2 percent of the taxpayer's adjusted gross income.[5]

An employee cannot choose to forego reimbursement for a business expense for which his employer would pay and claim a deduction. "[A] business expense deduction is not allowable to an employee to the extent that the employee is entitled to reimbursement from the employer for an expenditure related to his status as an employee."[6]

1. IRC Sec. 62(a)(2).
2. IRC Sec. 62(c), Treas. Regs. §§1.162-17(b)(2), 1.162-17(c).
3. Treas. Reg. §1.62-2.
4. Treas. Reg. §1.67-1T(a)(1)(i).
5. IRC Sec. 67.
6. *Lucas v. Commissioner*, 79 TC 1 (1982).