

Deducting Business-Pleasure Travel Expenses While Away from Home (Within and Outside the U.S.)

With summer upon us, we thought it would be a good idea to briefly discuss the rules for deducting the cost of your out-of-town business travel within and outside the U.S. With few exceptions, the rules apply similarly to employees and self-employed persons. It is important to note that these rules apply only if the business conducted out of town reasonably requires an overnight stay.

Within the U.S.

The actual costs of travel (e.g., plane fare, cab to airport) are deductible for out-of-town business trips. You are also allowed to deduct the cost of meals and lodging. Your meals are deductible even if they are “personal,” (i.e., not connected with business, although, as with all deductible meals, only 50% of the cost is allowed). Additionally, no deduction is allowed for meals or lodging to the extent the expense is “lavish or extravagant.”

Although personal entertainment costs on the trip are not deductible, business-related costs such as dry-cleaning, phone calls and computer rentals are permitted. You must allocate expenses if the trip is a combined business/pleasure trip. For example, if you fly to a location for five days of business meetings and stay on for an additional period of vacation, only the cost of meals, lodging, etc., for the business days are deductible. Expenses for the personal vacation days are not.

In contrast, with respect to the cost of the travel itself (e.g., plane or rail fares), if the trip is “primarily” business, it can be deducted in its entirety and no allocation is required. Conversely, if the trip is primarily personal, none of the travel costs are deductible. An important, although not sole, factor in determining if the trip is primarily business or personal is the amount of time spent on each.

If the trip does not involve the actual conduct of business, but is for the purpose of attending a convention, seminar or similar

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IRS Audits on the Rise: Are You at Risk?

In the spring of 2002 we revealed the Internal Revenue Service’s (“Service” or “IRS”) plans to step up its audit efforts by increasing the number of audits, moving to a risk-based audit system using statistical data compiled from returns and other public information, and by instituting the National Research Program, in which thousands of randomly selected taxpayers would be subject to intense line-by-line audits.

Since 2002, the IRS has substantially increased its enforcement measures. According to the IRS in testimony before Congress, over one million individual audits were conducted in 2004, and the IRS brought in a record \$43.1 billion in enforcement revenue, which was an increase of \$5.5 billion (or 15 percent) from the year before. Additionally, high-income audits have risen by 74 percent and criminal tax prosecutions have risen by 50 percent since 2002. However, most of the increase in individual audits is attributable to “correspondence audits,” which are less intrusive than “face-to-face” audits.

Earlier this year the IRS reported that the United States sustained a “gross tax gap,” which is the difference between what taxpayers should pay and what they actually do pay on a timely basis, of between \$312 billion and \$353 billion for tax year 2001. Preliminary findings from the National Research Program show that underreporting noncompliance is the largest component of the tax gap and that individual income tax is the single largest source of the annual tax gap, accounting for approximately two-thirds of the total. The preliminary findings show that for individual underreporting, more than 80 percent originates from understated income rather than overstated deductions, and that most of the understated income results from business activities, not wages or investment income.

The National Research Program was a three-year study that audited 46,000 individual income tax returns for 2001. The National Research Program introduced several innovations to the

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event, the IRS may investigate the nature of the meetings to ensure they are not vacations in disguise.

Travel costs of a spouse, dependent or any other individual who accompanies you on a business trip are not deductible unless that person is also an employee of yours or your company, has a bona fide business purpose for joining you and the expenses of such person are otherwise deductible.

Outside the U.S.

With respect to the deductibility rules for a business trip outside the U.S., if the trip is entirely for business purposes, you can deduct all the travel costs, plus meals (at 50%), lodging and some incidental costs, such as for laundry and dry-cleaning.

If the trip is primarily personal, none of the costs of travel to and from the destination are deductible, even if some time is spent on business. Lodging, meals and entertainment are deductible for the business days. The rules are more complex if the trip is primarily but not entirely for business. In this case, unless an exception applies as discussed below, the costs allocable to the personal (vacation) part of the trip cannot be deducted. For example, if the trip covers 10 days – four personal and six business – meals, lodging, etc., are deductible only for the business days. Furthermore, just 60% of the travel costs are deductible, reflecting the fact that only 60% of the days of the trip were business days.

The allocation of part of the travel costs to the non-deductible portion need not be made if the primary purpose of the trip is business and the trip does not last for more than a week. A week for this purpose means seven consecutive days, not counting the day of departure, but counting the day of return.

Even if the trip does last for more than a week, no allocation is required if the personal days total less than 25% of the total days spent on the trip. For this purpose, the total days of the trip include the day of departure and the day of return. Even if business is conducted on only part of a day, it is counted as a business day. Business days also include days spent traveling to or from a business destination and weekend days or holidays falling between two business days.

For example, Tom flies to Paris on a Monday primarily for business reasons. He spends Tuesday and Wednesday vacationing and then spends Thursday, Friday and the following Monday through Thursday on business before flying home Friday. Counting the days of return and departure, it is a 12-day trip. Only the first Tuesday and Wednesday are nonbusiness days. Thus, less than 25% of the trip is personal (two of 12 days). Except for meals and lodging costs for those two vacation days, the rest of the meals (at 50%) and lodging, and all of the travel costs are

deductible. The travel costs need not be allocated between personal and business because of the 25% rule.

If you do not satisfy the one week or 25% test, you may still be able to deduct all of the travel costs if you can show that the chance to take a vacation was not a major consideration for the trip. Of course, the larger the vacation portion, the more difficult it will be to support your position.

Whether your travel is business-related or combining business and pleasure, it is imperative to save all material helpful in establishing the business or professional nature of your travel. It is important to be thorough in preparing and maintaining adequate records since the burden is upon you to prove the business purpose of your travel.

The tax implications and record-keeping requirements of travel, particularly foreign travel, can get quite complex, depending on the nature of the trip. If you would like to discuss the complexities further, or would like us to review your planned domestic or foreign travel from a tax point of view, please feel free to contact us.

How *Not* to Guarantee a Deduction for Unreimbursed Business Expenses

It is important to maintain adequate records in order to substantiate a tax deduction. As a recent Tax Court opinion illustrates, employees who incur unreimbursed business expenses and seek to deduct them as business expenses must ensure that they comply with the “contemporaneous records” substantiation requirements. In other words, the following case is a roadmap for how *not* to guarantee your deduction for unreimbursed business expenses. Hence, you should do the opposite of what the taxpayer in this case did.

The Tax Court, in *Barton v. Commissioner*, held that certain automobile and entertainment expenses incurred by a sales representative could not be claimed since records purportedly “substantiating” them were prepared in preparation for trial, years later. Furthermore, because these types of expenditures are subject to the most strict substantiation requirements, they could not be estimated by the court.

Basic Law

The general rule is that the only way a taxpayer can substantiate amounts claimed as deductions is by maintaining the records necessary to establish that he or she is entitled to the deductions. If a taxpayer establishes that a deductible expense has been incurred but is not able to establish the amount of the deduction, the Tax Court may generally make an estimation of the expenses.

The court, however, must have some basis on which to make an approximation of the allowed expenses.

Certain business expenses are subject to more stringent substantiation requirements. No deduction is allowed for expenses incurred for travel expenses, specifically including meals, entertainment and automobile expenses, unless the taxpayer substantiates certain elements of the claimed expenses. Under the substantiation requirements, a taxpayer must substantiate the business purpose, time and amount of the expenditures and must provide adequate records or sufficient evidence to corroborate his or her own statement. Adequate records or sufficient evidence is defined as a diary, a log or a similar record and documentary evidence that, in combination, are sufficient to establish each element of each expenditure or use. Specifically, a record generally must be written and must be prepared at or near the time of (“contemporaneously with”) the use or expenditure. In contrast with the practice indicated above, the Tax Court may not estimate expenses subject to the strict substantiation rules, such as entertainment expenses and passenger automobile expenses. Thus, for these expenses, only strict substantiation will suffice.

Facts

James Barton was a sales representative for Armko Industries, Inc. (Armko), a roof system consulting firm, during 2000. He was responsible for consulting with clients, mainly school districts, regarding their roofing needs and helping them in overseeing the planning and implementation of roofing projects. A typical job lasted three months and required Barton to travel to the job site five times or more. During 2000, Barton’s clients were located in Texas and Louisiana, and Armko did not reimburse him for expenses related to his sales activities.

Barton claimed automobile expenses of approximately \$16,000, and meals and entertainment expenses of approximately \$2,400, as unreimbursed employee business expenses for 2000. Barton sued in Tax Court after the IRS denied the deductions. In court, with regard to the automobile expenses, Barton testified that he maintained a mileage log by recording the odometer reading for each sales call on the day that he made the sales call and then transferred this information into a spreadsheet on his personal computer because he wanted to have a “more efficient paperless office.” Barton maintained no other paper records for the business use of his automobile and, unfortunately for him, testified that in preparing for trial he reconstructed significant portions of the mileage log two years after the fact.

Barton computed the meals and entertainment deduction reflected on his return from his credit card company’s year-end summary statement. The credit card summary, however, listed only the

date, the name of the restaurant or other payee, and the amount of the item. It listed neither the name of the business contact being entertained nor the business purpose for the expense. Similar to the automobile use documentation strategy described above, he created an entertainment list six months before trial, which was more than three years after the expenses were incurred, on which he listed the name of the person with whom he ate meals, the name of the restaurant, his business relationship with the person, the business purpose and the amount for each meal.

Tax Court’s Decision

The Tax Court held that Barton was not entitled to deductions for the automobile and entertainment expenses he claimed in 2000 as a sales representative, since, due to his failure to contemporaneously maintain written records of each business trip and to record the information with the claimed expenditures, he did not satisfy the strict substantiation requirements.

With regard to the claimed automobile expenses, the court held that the mileage log was unreliable. The mileage log contained entries that, in some cases, contradicted other evidence or were, at best, inconsistent with other evidence. The court noted that, in some cases, there were entries on the same day on both the flight log on Barton’s personal airplane and the mileage log for his automobile that showed times and distances traveled that could not have taken place on the same day. At trial, Barton could not explain the discrepancies. Turning to the actual automobile expenses incurred in 2000, the court found that the master credit card summary showed expenses that reflected both business and personal expenses.

As to the claimed expenses for meals and entertainment, the court noted that the fact that Barton’s entertainment list was prepared more than three years after the fact, and that the master credit card summary did not show the business purpose of the activity or the name of the person being entertained, resulted in noncompliance with the tax substantiation requirements. Again, the Tax Court said that the meals and entertainment expenses reflected both business and personal purposes. There were also other discrepancies as well as no receipts or other corroborating evidence. Accordingly, the claimed expenses were disallowed by the Tax Court since they did not satisfy the strict substantiation requirements.

If you would like additional guidance with regard to substantiating your unreimbursed business expenses, or would like us to review your current substantiation policies, please feel free to contact us. |||

IRS Audits on the Rise: Are You at Risk?

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audit process that were designed to reduce the burden imposed on taxpayers whose returns were selected for the study. The first innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. This reduced the need to request information from taxpayers. The second major improvement of the National Research Program was to introduce a “classification” process whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors who identified the best way to handle each return. These along with other innovations help to reduce the burden that existed for taxpayers under an old system that examined every line of every return. These innovations are now being expanded into the IRS’ regular operational audit programs.

As a result of the National Research Program’s preliminary findings, and in an effort to reduce the tax gap, the IRS has recently declared that it is ramping up audits of high-income taxpayers and corporations, focusing more attention on abusive shelters and launching more criminal investigations. The IRS specified in its Strategic Plan for 2005 - 2009 that its priority areas for discouraging non-compliance include:

- Promotion and use of abusive tax schemes and avoidance transactions;
- Misuse of offshore transactions;
- Non-filing and underreporting of income by higher income individuals; and
- Flow-through income.

Additionally, the IRS has received modest budget increases over the past two years and has increased its spending on enforcement by almost eight percent. In 2004, the audits of large businesses (those with assets of \$10 million or more) increased and the IRS intends to do the same for small businesses in 2005.

What does all this mean and are you at risk?

If you are a high-income taxpayer, are self-employed, receive flow-through income from a partnership, S corporation or limited liability company and/or claim business deductions, you have an increased risk of audit as a result of the IRS’ focus.

The IRS uses two primary methods for identifying returns to be examined. The first is a computer program called the Discriminant Index Function or DIF. Under the DIF, your return is scored by mathematical formulas. The higher the “score,” the

higher the chances of an audit. Some of the items that may increase your DIF “score” and therefore increase your audit risk include:

- Higher income, greater than \$100,000;
- Income other than basic wages (contract payments, etc.);
- Large casualty losses;
- Large meals and entertainment deductions;
- Excessive business auto use;
- Low gross profit margin from self-employment income;
- Low income with large business deductions;
- High non-cash charitable deductions;
- Hobby losses; and,
- Little or no profit from a business operation.

The Market Segment Specialization Program (MSSP) is the second primary method used for selecting returns. The MSSP focuses on the industry the taxpayer is in rather than on what type of return the taxpayer files, the amount of gross income reported or the ratio of deductions to income. Compliance activity is organized around market segments, where practical. A market segment can be an industry, such as manufacturing; a professional group, such as attorneys; or an issue, such as passive activity losses. The IRS has released audit guides on 75 industries, professions and issues. Individual market segments are then assigned to examiners with auditing experience, training and research responsibilities in that area. The most recent of the 75 audit guides highlights the IRS’ guidance on payments and perks given to departing or retiring executives, including such compensation issues as the treatment of club memberships, qualified employee discounts, home improvements, personal use of a company’s aircraft and qualified retirement planning. Furthermore, Internal Revenue Service officials announced, as we were going to press, the launch of a study to assess the reporting compliance of S corporations. The study, carried out under an expansion of the National Research Program described above, will examine 5,000 randomly selected S corporation returns from tax years 2003 and 2004.

Once a return is selected for examination under a risk-based audit system, revenue agents and group managers exercise professional judgment on whether the returns should simply be surveyed or examined. Additionally, revenue agents utilize public information to assist them in determining the audit potential of a return. For example, an agent may check public records to see the average price of homes in a taxpayer's ZIP code. If the average cost of a home is \$500,000 and the return shows inadequate income to sustain such a lifestyle, it is likely to be scrutinized further. Revenue agents also engage in pre-audit planning, which includes communication with a taxpayer's accountant, which helps to reduce the number of issues under examination. Agents are also encouraged to consult with divisional counsel for guidance on tax law matters and on issue development, which helps to reduce or eliminate issues from moving forward due to an agent's misunderstanding of the law.

A few years ago the IRS reorganized into four separate compliance functions: Wage and Investment; Small Business/Self-Employed; Tax-Exempt and Governmental Entities; and Large and Mid-Size Businesses. Each of the divisions has a compliance function. Wage and Investment (W&I) taxpayers will probably have no personal contact with the compliance function since most of the W&I audits will be conducted by mail. However, issues that cannot be resolved by mail, phone or electronically are referred to the Small Business/Self-Employed Division. Small Business/Self-Employed taxpayers can expect to see an increase in the number of audits in the next few years.

Changes to the IRS audit process as a result of the National Research Program are a work in progress. No one, including the IRS, can predict exactly how the compliance function will work in the future. However, it is certain that the IRS is increasing its enforcement efforts, and it is important for you as a taxpayer to bring your files up-to-date in an organized fashion to avoid any proposed adjustments to your tax return. Additionally, taxpayers may wish to engage a professional to conduct a "simulated audit" for the purpose of reviewing record keeping policies, existing tax positions and obtaining advice on correcting problems or deficiencies that would be likely targets in the event of an actual IRS examination. We have received numerous inquiries regarding "simulated audits" and are currently conducting such audits for our clients.

In the event you are contacted by the IRS and informed that your return is being audited or that an adjustment is being made to your return, please contact us. Even if the IRS is correct in making the adjustment, there may be an error in the recalculation of tax. We recently represented a couple in a case in which the IRS made an error in calculating an adjustment to their return that was not uncovered by their previous lawyers and accountants. We identified the error and successfully negotiated with the IRS to save the taxpayers more than \$400,000 and arranged for the release of all levies.

If you would like more guidance in this area or have been contacted by the IRS, please contact us and we will be happy to represent you. |||

Tax Accounting Group News

The Tax Accounting Group and Duane Morris are pleased to announce that our Philadelphia office is relocating. All phone and fax numbers remain unchanged. The new address takes effect August 22, 2005:

**United Plaza
30 South 17th Street
Philadelphia, PA 19103-4196**

Michael Gillen, Director of the Tax Accounting Group, was recently spotlighted in the July 22-28, 2005 issue of the *Philadelphia Business Journal*. The article discussed the growth of our group as well as our service lines, provided client and peer testimonies, and made several mentions of Duane Morris. This article was also picked up by the *Daily Bankruptcy News*, which is circulated by e-mail to bankruptcy lawyers throughout the United States.

Bruce Rogers, CPA, JD of the Tax Accounting Group, recently published in the *Pennsylvania CPA Journal*, Summer 2005 edition, has also been published in the *Louisiana CPA Journal*. Mr. Rogers authored "A Brush-Up on Basic Rules for Retirement Plans," an article which discusses how CPAs need to remember the retirement plan basics when designing an overall personal financial plan.

Mary Beth Lee, CPA, CFE, has successfully negotiated with the IRS a compromise of a taxpayer's federal income tax liability whereby a \$2 million liability was settled for \$110,000 and with the Commonwealth of Pennsylvania whereby a \$120,000 liability was settled for \$20,000. In addition, she successfully represented another taxpayer before the Internal Revenue Service Collection Division by arranging for the release of levies, a reduction in assessed tax of about \$400,000 and abatement of interest and penalties of approximately \$50,000.

About Duane Morris

Duane Morris LLP, among the 100 largest law firms in the United States, is a full-service firm of over 550 lawyers. In addition, Duane Morris affiliates have approximately 50 professionals engaged in ancillary service businesses, such as the Tax

Accounting Group. The firm represents clients across the nation and around the world through a combination of 17 offices and a relationship with an international network of independent law firms. |||

About the Tax Accounting Group

The Tax Accounting Group, one of the largest groups of its kind in any law firm, has an active and varied practice with more than 60 service lines in more than 45 industries, serving clients in 43 states and eight foreign countries. The Group's certified public accountants, certified fraud examiners, financial consultants and advisors provide a broad range of cost-effective tax preparation, planning and consulting services as well as accounting, financial and management advisory services to individuals, corporations, partnerships, estates and trusts and nonprofit organizations. The

Group also provides an array of litigation consulting services to numerous lawyers and law firms representing clients in regulatory and transactional matters and throughout various stages of litigation. Consulting services include, but are not limited to, case assessment and strategy development; asset recovery investigation and locator services; damage assessment; marital disputes; forensic and investigative accounting; fraud and embezzlement detection; and civil and criminal tax controversies. |||

Tax Accounting Group

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