

Tax Reduction Letter

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It's Ski Season—Let's Make Your Skiing Deductible

This article is for the businessperson who likes to ski. Professional skiers and ski bums will have to find another source of information to learn how to deduct their skiing.

Here is the critical rule to keep foremost in your mind: For you, the businessperson, skiing is deductible only as “associated entertainment.” This means that you need to have a business discussion in a business setting before or after the skiing, generally within 24 hours.

This article is going to give you the nuts and bolts of the skiing deduction. You will learn

- that ski deductions start with business discussions in a business setting;
- that conventions, meetings, and seminars are automatically business discussions;
- that the ski hill and the chair lift are not business settings;
- that skiing qualifies for deduction when it is associated entertainment;
- that the costs for your spouse and children can qualify for deductions as well;
- how to get the biggest lodging deductions; and
- when skiing in a charitable event doubles your deductions.

The Skiing Deduction Starts with a Business Discussion in a Business Setting

The first step to qualify your skiing for a deduction is to have a

bona fide business discussion in a business setting.

To crystallize what constitutes a business setting, think “table and chairs.” A business conversation in a restaurant qualifies as taking place in a business setting.¹ Thus, having a business discussion over breakfast, lunch, or dinner can qualify as directly related entertainment—and that, in turn, makes the associated skiing deductible.

Conventions, Meetings, and Seminars Are Automatic Business Discussions

You are going to like this rule: IRS Regulation 1.274-2(d)(3)(i)(b) says that a convention or similar meeting is automatically a “clear business setting.”

Thus, skiing with other conventioners on the day before, day of, or day after the convention qualifies as associated entertainment.

Two-Person Seminar

In the October 2008 issue of *Tax Reduction Letter* (Vol. 17, No. 10), we discussed the two-person seminar. This seminar qualifies as a bona fide meeting. Therefore, like the convention, skiing the day of, the day before, or the day after such a seminar qualifies as associated entertainment.

[See Ski Pg 2, Col 1](#)

Discriminate with Your 105 Plan

Do you want your Section 105 medical reimbursement plan to provide maximum benefits to you and your family and none to your employees? If so, you need to make a discrimination plan allowed by both tax law and ERISA.

The Section 105 medical reimbursement plan allows the sole proprietor or single-member limited liability company (LLC) to cover an employee-spouse with a Section 105 family medical reimbursement plan. You, the owner, can't accomplish this benefit for yourself without either hiring your spouse or creating a C corporation.

If you are single, you can obtain the benefits of the 105 plan for yourself by doing business as a C corporation. You need to know the discrimination rules, however, so you can cover yourself with a Section 105 plan that discriminates against your other employees.

Similarly, if you are married and not able or willing to hire your spouse, your choice of entity to

[See Discriminate Pg 4, Col 2](#)

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Ski Hill and Chair Lift Are Not Business Settings

The ski hill and the chair lift are not business settings under IRS Regulation 1.274-2(c)(4), which states that you may not deduct entertainment when it occurs under circumstances where you have little or no possibility of engaging in the active conduct of your business. According to this regulation, you have little or no possibility of engaging in the active conduct of your business

- when you are absent;
- when the distractions are substantial, such as attempting a discussion at a nightclub, theater, or sporting event; or
- when your discussion includes both business and nonbusiness associates at cocktail lounges, athletic clubs, and vacation resorts.

Skiing That Qualifies for Deduction

Personal skiing is not deductible. Tax law forbids deductions for any personal, living, or family expenses.²

Your business skiing is deductible when you ski with those with whom you had the business discussion and you do this before or after the business discussion. The same day always qualifies.³

Facts and circumstances determine the other days. Generally, when you are sleeping in lodging at the ski hill, the cost of skiing the day before or the day after a bona fide business meeting qualifies for deduction as “associated entertainment” under IRS Regulation 1.274-2(d)(2).

Dutch-treat business skiing is deductible. The law does not require you to pick up the tab for the other skiers.⁴ Thus, you can pay for only yourself, and that is just as deductible as if you had picked up the tab for the group.

Deduct the Cost of Your Spouse and Children, Too

IRS Regulation 1.274-2(d)(4) says that you can deduct the cost of entertaining your spouse as a closely connected person when your entertainment qualifies as directly related entertainment. The regulations also state that when the

entertainment combines business with a ski trip, you must clearly establish that the active conduct of business was the principal character of the trip.⁵ The presence of your nonbusiness spouse makes this more difficult.

Further, Revenue Ruling 63-144 says that to deduct the cost of your spouse under the “closely connected” rule, you need an ordinary and necessary business reason for the spouse to come with you to the mountain.⁶ This is a facts-and-circumstances test that poses difficulties for a ski trip.

“Necessary” means that the expense is “appropriate and helpful” to your business.⁷ “Ordinary” means that the expense is a common and accepted practice for the business.⁸

You can see that deducting the costs of bringing your nonbusiness spouse with you to the mountain is far more difficult than if you were bringing your spouse to a business dinner in town.

The difficulty disappears if your spouse works in your business. In this case, your spouse comes to the mountain for business meetings, just as you are at the mountain for business meetings.

If your spouse does not work in your business, you need to satisfy the ordinary and necessary reason for your spouse’s presence at the mountain. Then, if your skiing qualifies as associated entertainment, your spouse’s skiing also qualifies for deduction as associated entertainment.⁹ If you can deduct dinner as directly related entertainment or associated entertainment, then your spouse’s dinner is deductible.¹⁰

You face the same rules when you bring your children to the mountain. You must pass the ordi-

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nary and necessary business reason test to deduct your children's costs of skiing and meals under the rules above. (This is not impossible but not likely either.)

Planning note. Your deduction for business skiing is easiest when you leave your spouse and children at home.

Getting the Biggest Lodging Deduction

To get a deduction for your lodging on this ski trip, you need to make the purpose of the trip business and not entertainment.

- If the lodging is for entertainment purposes, you trigger the entertainment facility rules that give you zero deduction for your cost of lodging.¹¹
- If the lodging is for business purposes, you trigger the business travel rules that allow a 100 percent deduction for lodging.¹²

Thus, with planning, you can make this trip a business trip and deduct the lodging as a business expense. Furthermore, you may deduct your meals in one of three ways:

1. Travel meals required by the trip
2. Directly related entertainment meals
3. Associated entertainment meals

Finally, you deduct the skiing as associated entertainment.

Example. You get up in the morning and attend a business meeting that lasts two hours. You then ski with participants from the meeting, and after the ski lifts close, the meeting resumes for another two hours and 20 minutes.

In this case, you have a business day. Your lodging the night before

In the News

Big Budget Deficit

The Congressional Budget Office on January 7, 2009, issued its annual report on the budget and economic outlook, estimating that under current law the federal budget deficit for fiscal 2009 will be \$1.2 trillion, or 8.3 percent of GDP—more than 2½ times the size of the deficit in fiscal 2008, which itself was by no means small.²² ■

qualifies as business lodging for this business day. Your lodging the night after the meeting also qualifies as business lodging.

Charity Skiing Doubles Your Deductions

There is one type of skiing that does not suffer the 50 percent cut that applies to entertainment. Under this exception, you deduct 100 percent of your entertainment expenses when your entertainment is at a ski event that¹³

- is organized for the primary purpose of benefiting a 501(c)(3) charity;
- gives the entire net proceeds to that charity; and
- uses volunteers to perform substantially all of the event's work.

If you buy a package deal that includes the charitable skiing event, your 100 percent deduction applies to the package cost.¹⁴

A Working Example of a Deductible Ski Trip

You go to the ski hill with three of your colleagues. For ordinary and necessary business reasons,

the four of you bring your families. On the evening of arrival you have a dinner with the families. The next morning you and your three colleagues have a spirited business seminar in the ski lodge's meeting room from 6:30 a.m. to 8:30 a.m. Then, you and your colleagues join the families on the mountain and ski until the lifts close at 4:00 p.m. Shortly after the lifts close, you and your colleagues assemble again for further discussion on how to improve your businesses. This second business session goes on for more than two hours.

Let's stop here and review the results so far:

- Lodging the night before is required for the business meeting and therefore deductible in full, assuming no extra costs for housing your spouse and children (if you incur extra costs for the additional occupants, then those costs are personal).
- Your dinner the night before the skiing is deductible as associated entertainment. Since your dinner is associated entertainment, so, too, are the dinners of your spouse and children.
- The four families assemble for lunch and dinner the day of the meetings. The rules and results for associated entertainment make those two meals deductible.
- If you pay just for yourself and your family, the business costs are deductible as Dutch-treat entertainment.
- The cost of the morning breakfast for family members is personal and therefore nondeductible.
- The cost of the morning breakfast that you ate alone is deductible as a travel expense.
- You deduct the cost of your lift

tickets as an associated entertainment expense.

- You deduct the cost of the lift tickets for your spouse and children as associated entertainment.

Summary

The first thing to get straight with the skiing deduction is that it is deductible as associated entertainment. Thus, you need a bona fide business discussion in a business setting before or after the skiing.

If you are going to stay overnight and you want to deduct the cost of the lodging, you need to insert some business days. Remember, lodging for entertainment purposes is not deductible.

There are various ways to structure business days. Perhaps the most common and easiest to document are those days on which your directly related business activities take more than four hours. Also, if you attend a convention, meeting, or seminar for more than four hours, you have a business day. Plan accordingly.

If your spouse does not work in your business and you want to deduct some of your spouse's expenses, you need to justify a facts-and-circumstances business reason for your spouse's presence.

If your spouse works in your business, your spouse has the same need for business meetings as you have.

You are probably going to deduct most of your lift ticket costs as business entertainment where the deductions in your tax return suffer the 50 percent cut. Your only escape from this cut is the ski event organized and run primarily by volunteers to benefit a 501(c)(3) charity.

When you know how to deduct your ski trips, your runs down the hill are happier. ■

Discriminate, from Pg 1

obtain the Section 105 medical reimbursement benefit is the C corporation.

Discrimination with the Section 105 medical plan is perfectly legal within the parameters set forth in the law and discussed in this article.

Beware of the Tainted Spouse

You may have more employees than you think. For purposes of a Section 105 medical reimbursement plan, your employees include those employed by³²

- your controlled corporations, LLCs, partnerships, and proprietorships; and
- your spouse's controlled corporations, LLCs, partnerships, and proprietorships.

Thus, you must consider all your businesses and all of your spouse's businesses in your plan of discrimination.

Discriminate against All or Fail

In setting forth your original or amended employee qualifications for 105 plan benefits, you need to apply the requirements to ALL employees. If you do not, then the IRS deems the plan discriminatory under IRC Section 105(h).³³

Thus, if you are establishing a Section 105 plan as the employee-owner of either your C corporation or your employer-spouse proprietorship, you need to consider ALL current and future employees when you establish your plan for discrimination.

Example. You begin your first business today and hire your spouse as your first and only employee. You expect to hire an additional employee 18 months from now. Do you want to cover this new employee with the Sec-

tion 105 medical plan? If not, you should consider that when you first adopt the plan.

IRS Tells Its Examiners to Look Closely

When examining a proprietorship's 105 plan that covers the owner's employee-spouse, the IRS tells its field force to look closely at the eligibility provisions of the plan to see if the employee-spouse qualifies for benefits.³⁴

Example. Your plan does not cover employees who work part time, which you define as less than 25 hours a week according to the tax-law definition. To pay 105 plan benefits to your spouse, you need proof that your spouse works more than part time.

If single and operating as a C corporation, apply this rule to yourself as the employee-owner.

The IRS also tells its examiners to look at your spouse's relationship to the business because your spouse might be³⁵

- an independent contractor,
- a co-owner of the business, or
- a joint venture operator with you.

The Plan Document

You should put your plan in writing on Day One of the plan. Further, you should evidence delivery and acceptance of the plan in writing.

If you are the sole owner of your C corporation, this means you sign the document both as an employee and as president or chief operating officer.

If you are establishing the plan in your proprietorship to cover your employee-spouse, you want the plan document signed by both you (the owner) and your spouse (the employee).

The first reason you want the plan documents in writing and

signed is to comply with IRS Regulation 1.105-11(b), which defines a self-insured medical reimbursement plan as a *separate written plan* for the benefit of employees that provides for reimbursement of employee medical expenses referred to in section 105(b).

For ERISA purposes, you do not need a written plan until you hire a nonspousal common law employee, because neither the owner nor the owner's spouse are considered employees under ERISA.³⁶

Once you hire your first non-spousal common law employee, you then have to deliver a "summary plan description" to that employee within 90 days of that employee's coverage by the plan.³⁷

Planning tip. Create a plan document on day one that, first, allows for the discrimination you want and, second, complies with both tax law and ERISA. To obtain a sample Section 105 plan document in Microsoft Word that you can modify and use, go to the *Tax Reduction Letter* Web site at www.taxreductionletter.com/105doc and download the document.

Filing and Reporting Requirements

The filing and reporting requirements for your Section 105 plan are so easy that they will bring a smile to your face.

First, you report your cost of the Section 105 plan in your tax return where you see the line item for employee benefit programs.³⁸

Second, when your plan covers 100 or more participants, you must file Form 5500.³⁹

Third, you should have a signed copy of the plan document from all employees who qualify to participate in the plan.

Discriminate against New Employees

IRS Regulation 1.105-11(c)(2)(iii)(A) allows you to exclude ALL employees who have not completed three years of service prior to the beginning of the plan year.

The term *year of service* means a 12-month period during which the employee has 1,000 or more hours of service.⁴⁰ This is the safe-harbor "reasonableness" rule that you can use to define a year of service. The law allows you to prove a year of service by other reasonable means, but for a husband-and-wife-owned business, we recommend that you stick with the safe harbor.

The 1,000-Hour Rule Can Work for or against You

For you. Your spouse has completed three years of service, working more than 1,000 hours a year. Your plan excludes employees who have not completed three years of service. Perfect: Your spouse is going to work more than 1,000 hours for each of the next three years, making him or her eligible for the Section 105 plan. The new employees will not qualify under the "years of service requirement" for three years.

Against you. Your employee-spouse has been working 500 hours a year. Under the safe-harbor rule, your employee-spouse has yet to complete one year of service. Thus, should you design your plan to exclude employees who have not completed three years of service, you must exclude your employee-spouse as a member of this group.

Things to Know about the Three-Year Rule

Although you can exclude under-age-25, part-time, and seasonal employees from the Section 105 plan, as we discuss below, you must count their qualifying years

of service for the three years of service rule.⁴¹

Example. You have properly excluded Jim Smith from your Section 105 plan for the previous four years because he was under age 25 at the beginning of each plan year. Now, Mr. Smith is age 25 at the beginning of the plan year, and you must count the four prior years as years of service for purposes of the three-year rule.

Should an employee separate from service, the IRS says that for purposes of the three-year rule you do not count the years of service prior to separation.⁴²

Example. Before he quit, you employed John Booth full time for five years. It's two years since he quit. You hire him back. You count nothing for Mr. Booth's five years of full-time work.

Discriminate against the Young

You may exclude from your Section 105 plan ALL employees who have not attained age 25 prior to the beginning of the plan year.⁴³

Discriminate against Part-Time Employees

You may exclude all part-time workers from your Section 105 medical reimbursement plan. Who qualifies as a part-time worker? The IRS gives you a safe-harbor classification: Any employee whose customary weekly employment is less than 25 hours may be considered a part-time employee.⁴⁴

Discriminate against Seasonal Employees

You may exclude all seasonal workers from your Section 105 plan. As with the part-time employee, the IRS gives you a safe harbor: Any employee whose customary annual employment is less than seven months may be considered a seasonal employee.

FREE Plan Document for You

We have put together the basic provisions that you should include in your summary plan description document to comply with tax law and ERISA law requirements, including the discrimination rules discussed above. You can download a Microsoft Word copy of this document that you, your tax preparer, and your lawyer can modify, by going to www.taxreductionletter.com/105doc. This

sample document will save you time, money, and trouble.

Remember, tax law requires a summary plan description, and ERISA law requires that you give it to all common law employees when they are covered by the plan. Other than having the plan in writing, you have no Form 5500 or other reporting requirements to worry about until you have 100 or more employees. ■

You don't want business receipts in your personal accounts or personal receipts in your business accounts. The separate checking gives you the ability to avoid commingling which is something to avoid always.

When the IRS gets confused looking at your accounts, it simply taxes all the income. True, you might be able to undo that assertion and prove that all the deposits are not taxable, but that takes time and effort. By simply getting the deposits right to begin with, you save yourself from confusing the IRS—which saves the IRS, in turn, from frustrating you.

Tips to Audit-Proof Your Records

You may hate the keeping records part of the tax system, but it's critical to your tax health. It's also important to your business health. Good records help you monitor and improve your business.

Do not depend on the IRS for mercy when it comes to your tax records. You will never find the word "mercy" in the same sentence with the IRS. It does not exist in the code or the regulations.

Since there is no mercy, you have no choice but to get your records right. Getting your tax records right is not difficult when you know what to do. This article gives you the record-keeping basics you need and helps you spend less time keeping records.

Checking Accounts

The first rule to keeping good records: Do not commingle activities in your checking accounts. Most taxpayers should maintain separate checking accounts for

- husband,
- wife,
- each separately reported Schedule C business,
- each corporation, and

- rental property (if there are substantially different types of rentals, then additional separate accounts may be necessary here).

Example. You operate your business as a proprietor and cover your spouse with a Section 105 medical reimbursement plan. If you have only one checking account for the family and the proprietorship, writing the reimbursement check to yourself likely would destroy the Section 105 plan.

That's how Darwin Albers lost his Section 105 plan deductions.¹⁵ The Albers case is just one example of how using a joint account for both business and personal reasons causes a loss of deductions.

Rule 1. Maintain a separate checking account for each business activity.

Deposit Receipts in the Account for the Business That Earns the Money

You may not earn income in your personal name and then assign that to your corporation. Income is taxed to the person or entity that earns it.¹⁶

Record Deductible Expenses Daily

We heard you screaming when you saw the word "daily" above. Don't worry, the daily requirement, which actually existed for auto expenses in 1984, was repealed and replaced with an adequate records requirement. So the IRS now gives you a week to meet the "timely" and "adequate" records requirements for vehicles, travel, entertainment, and listed property.¹⁷

We doubt that you will, but you probably should thank the IRS for the one-week rule. Why? Because recording your business expenses within one week makes good business sense. After all, if you wait too long, you won't remember the nature or reason for the expenses.

Keep Logs

To deduct your vehicle expenses, you need proof of business use. This is true regardless of the form your business takes. Thus, if you operate as a corporation, you (the employee) must submit proof of your business use to the corporation.

We recommend that you keep your vehicle mileage in your

appointment book so it reflects your business activities for each day. Further, the appointment-book recordings facilitate use of a sampling method, such as the three-month log of business miles to prove business use for the year.¹⁸

If you own rental properties, you should track for at least three consecutive months the time spent on the rentals, to prove material participation and, if applicable, real estate professional status.

If you claim a deduction for an office in the home, you should track time spent working in the home office. Your use of the home office must meet the “regular use” test. If you use your home office a little more than 10 hours a week on a consistent basis, you meet the requirements for regular use as set out in *Green*.¹⁹

Record Required Elements of Travel and Entertainment

Regardless of business form, you need to prove, for each day of travel, where you were and why you were there.

For entertainment, you need to record who, what, when, where, why, and how much. You can meet all these requirements by adding a short note to the receipt with the

- name of the person you entertained, and
- why you entertained this person.

The “why” should relate to the immediate or future business benefit you hope to achieve with the entertainment. Try to keep the “why” explanation to seven words or less.

We made up this seven-word guideline and have used it successfully for the past 30 years because it makes for a clear explanation of the entertainment activity. Further, you have additional corroborative evidence in your files and e-mails.

The receipt contains the remaining documentation for

- what (e.g., food, drinks, golf);
- when (date);
- where (name and address of the place); and
- how much.

If you operate as a corporation, you need to turn the documentation in to the corporation, and the corporation needs to either pay for the entertainment and travel expenses directly (say, with a corporate credit card) or reimburse you for the amounts spent. Make certain the corporation pays. You do not want to claim deductions for these expenses as employee business expenses.

Best Advice

For all expenses, from the purchase of your desk to pens for your office, keep these two points in mind:

1. You need to prove what you bought.
2. You need to prove that you paid for what you bought.

Step 1: What you bought. Generally, the receipt or invoice will prove both the description of what you bought and how this purchase relates to your business. With entertainment at a restaurant, the receipt that proves what you bought is the receipt that shows the details of what you had to eat and drink.

Step 2: What you paid. Tax law considers the charge to a credit card as payment, regardless of when the card gets paid.²⁰ Thus, you can prove payment by credit card with either the credit card receipt that shows the total charge or the credit card statement.

The canceled check proves payment by check. The bank statement proves payment by electronic transfer.

As a general rule, don’t pay in cash. These are the first questions

an auditor will ask about a cash payment:

- Where did the cash come from?
- How good is the trail of cash to the payment?
- Was an ATM withdrawal evident before the cash payment?
- Did the taxpayer really spend the cash or just make up this deduction?

You face no such questions for payments by check or credit card.

Petty Cash

For most small businesses, a petty cash system is a disaster. If you have such a system and it works well for you, fine. If not, use the reimbursement method.

Under the reimbursement method, if you or an employee spends money on behalf of the firm, you simply have the firm write a check to reimburse the expense based on documentary evidence such as

- a receipt for the expenditure, and
- an expense report for the auto mileage, if applicable.

The reimbursement method is direct, clear, and less subject to mistakes than the petty cash system.

Statute of Limitations

The “statute of limitations” refers to the period of time when you and the IRS can make changes to your tax returns. Most taxpayers think of the limitation periods as the time frames during which the IRS can audit returns. The periods laid out in IRS publications are listed below:²¹

- Three years, if you filed on time or with extensions and did not understate your income by 25 percent or more, and did not file a fraudulent return
- Six years, if you filed on time or with extensions but under-

stated your income by more than 25 percent

- Forever, no limit, if you filed a fraudulent return
- Forever, no limit, if you did not file a return
- Three years after filing or two years after the tax was paid, if you filed an amended return or other change to your original return, such as a quick claim for refund
- Seven years, if you filed a claim for a loss from worthless securities or a bad-debt deduction

If you have employees, you must keep your employment tax records for four years after the date the tax was paid or due, whichever is later.

How Long to Keep Records

The statutes of limitations tell you the time period during which the IRS can audit your returns. If your returns are examined, you need tax records that prove your deductions. This means you need to keep your records for longer than you might think.

Assets. Assets such as your car, desk, computer, and office building are relevant to your tax return during their depreciable class lives.

- If you are depreciating the assets, the depreciation shows up in those returns.
- If you used Section 179 to expense the assets, then you

have potential recapture during the depreciable class life.

Example. You buy a \$1,500 desk and depreciate it over the seven-year MACRS life (this takes eight years). In year eight, you still have to prove the depreciation. That means you need the original purchase record in year eight. You also need the purchase record in year eleven to meet the three-year statute of limitations on this year eight deduction.

If you used Section 179 expensing on this desk, your records requirement is identical to the example. You have recapture exposure during the eight years, and you need to hold onto your proof of purchase for three years beyond that, or 11 years in total.

Make this easy. For any asset that has a life of more than one year, keep the purchase records in a permanent file. With a separate permanent file of asset purchases, you don't have to think or worry about class lives or limitation periods.

The five-drawer method. To use the five-drawer method, you need to keep your permanent files in another place (such as a different set of file drawers). Next, you must report your income and file and pay your taxes on time or with extensions, to limit your audit exposure to three years from the date you filed your return. If

you fit this profile, the five-drawer system can simplify your records retention. It works like this:

- Drawer 1: Accumulation of current year tax return information
- Drawer 2: Last year (tax return filed this year, say on April 15)
- Drawer 3: Two years ago
- Drawer 4: Three years ago
- Drawer 5: Four years ago

At the beginning of each year, the contents of drawer 5 go to the dump and all drawers move down one notch.

Employment taxes. If you have employees, you must keep all employment tax records for at least four years after the date the tax becomes due or is paid, whichever is later. Again, simplify. If you have employees, use a six-drawer method. Toss the sixth drawer when your four-year statute expires.

Thoughts That Make Keeping Records More Pleasant

Think of your business records in the way you think of golf handicaps and batting averages. The records tell you what you need to do to continue improving.

The fact that the tax law requires the records is another incentive to keep them. But really, if no tax law existed, as a businessperson you would want records that show you where you have been and where you might go. ■



Answers to Questions from the Readers



Weekly Lunches

Periodically, I gather in a new client with whom I will have weekly meetings for 18 consecutive months on the person's finances and investments. Often these meetings occur during a lunch for which we go "Dutch

treat." I write off the lunches but worry that I am violating the *Tax Reduction Letter* guideline on too many lunches with the same person or perhaps too many lunches in one year. What do you say? (E. W., Houston, Texas)

The IRS has a whimsical tool at its disposal called the "Sutter rule." Under this rule, the IRS can assert

whenever it so desires that the taxpayer is having meals that absorb otherwise personal expenses.

Planning note. Every business meal absorbs your personal consumption, and the IRS allows that consumption as a business expense almost all the time. But the IRS can, whenever it gets the urge, invoke Sutter.

Now, let's get to your situation. First, the legislative history does not consider the "Dutch treat" lunch, as the history indicates that it is disallowing 50 percent of your lunch as if you were paying for yourself and your client.

(Note that when you entertain four clients, the 50 percent rule truly penalizes you because your part is only 20 percent, but you lose 50 percent. Fairness is not a prerequisite for a tax law. In fact, with many of the most unjust laws, like the alternative minimum tax or the passive loss rules, lawmakers use a fairness rationale to justify these most unfair results.)

We think that the IRS could apply the Sutter rule to your Dutch treat lunches and that the courts likely would follow the Sutter rule.

In the 2003 *Weeldreyer* case, the court stated: "In order for personal living expenses to qualify as a deductible business expense under Section 162(a), the taxpayer must demonstrate that the expenses were different from, or in excess of, what he would have spent for personal purposes."²³ This explanation follows both *Sutter*²⁴ and Revenue Ruling 63-144, question and answer 31.

Sutter was a medical doctor practicing industrial medicine who claimed ordinary and necessary business deductions for his cost of lunches incurred while attending local Chamber of Commerce meetings. The court noted that Sutter had no evidence that his cost of the lunch at the Chamber of Commerce meeting was greater than a lunch he would have otherwise purchased for personal purposes.

Thus, you can see that the IRS has precedent to subject your lunches to the Sutter rule. Generally, it does not, but it could.

For your protection, obtain proof that the lunches cost more

than your personal lunches and that this is not an everyday event. You build more protection if you can prove that you have no personal relationship and only a business relationship with this client.

Say you generally bring a bag lunch or slip out for lunch to the inexpensive deli next door to your office, but when you meet with this client, you spend considerably more than you spend on the bag or deli lunch. If you have proof of this, you can beat the Sutter rule.

Keep in mind that the IRS does not invoke Sutter except in cases that the IRS deems abusive. Your weekly lunches do not seem to fit the abusive category. Thus, if we were in your shoes, we would deduct the lunches and not worry about Sutter. ■

Recruiting Expense

I attempted to hire the wife of a past client to work in my business. I met her in San Francisco, where she lives with her husband, my client. I invited her to Arizona. She paid airfare and I paid for her lodging, meals, and other expenses here. My attempt at this hire was not successful. May I still deduct the expenses? (K.W., Scottsdale, AZ)

Absolutely, unless there is more to this than you are telling us.

Let's say that you have no meaningful personal relationship with this woman.²⁵ You invite her to Arizona for the sole purpose of hiring her. The interview took about an hour and a half, and nothing came of it. You were expecting more and had agreed to cover the expenses for a three-day stay in Arizona. No problem. The amounts you are paying are clearly ordinary and necessary business expenses.

If there is a personal relation-



Endnotes



- 1 See *Judy Dunkelberger v Commr.*, T.C. Memo 1992-723, for an example of when meals in a restaurant qualify as directly related entertainment.
- 2 IRC Section 262.
- 3 Reg. Section 1.274-2(d)(3)(ii).
- 4 Reg. Section 1.274-2(b)(1)(ii).
- 5 Reg. Section 1.274-2(c)(3)(iii).
- 6 Rev. Rul. 63-144, Q&A 26.
- 7 *Welch v Helvering*, 290 U.S. 111, 113 (1933).
- 8 *Ibid.*
- 9 Rev. Rul. 63-144, Q&A 25 allows associated entertainment for the spouse. Reg. Section 1.274-2(d)(4) restricts the closely connected deduction to directly related entertainment. Reg. Section 1.274-2(d)(2) allows associated entertainment for the spouse. Based on these regulations, we conclude that you may deduct the cost of your spouse under the closely connected rule as it relates to both directly related and associated entertainment.
- 10 *Ibid.*
- 11 Reg. Section 1.274-2(e)(2)(i).
- 12 Reg. Section 1.274-2(b)(1)(i).
- 13 IRC Section 274(l).
- 14 IRC Sections 274(n)(2)(C); 274(l)(1)(b); IRS Pub. 463, *Travel, Entertainment, Gift and Car Expenses (2007)* p. 12.
- 15 *Darwin J. Albers v Commr.*, TC Memo 2007-144.
- 16 *United States v Basye*, 410 U.S. 441, 449, 451 (1973); *Lucas v Earl*, 281 U.S. 111 (1930).
- 17 IRS Pub., 463, *Travel, Entertainment, Gift, and Car Expenses (2007)*, Chap. 5, Record Keeping; Reg. Section 1.274-5T(c).
- 18 IRS Reg. Section 1.274-5T(c)(3)(ii)(C), Example 1.
- 19 *John W. and Regina R. Z. Green v Commr.*, 78 TC 428 (1982), reversed on other grounds, 707 F2d 404 (CA9, 1983).
- 20 E.g., Rev. Rul. 78-38; Rev. Rul. 78-39.
- 21 IRS Pub., 583, *Starting a Business and Keeping Records (Rev. January 2007)*, Record Keeping.
- 22 2009 TNT 4-23.
- 23 *Ronald D. Weeldreyer v Commr.*, TC Memo 2003-324.
- 24 *Sutter v Commr.*, 704 21 T.C. 170 (1953), acq., 1954-1 C.B. 6.
- 25 With no meaningful personal relationship, you would have nothing other than a business motivation to conduct this interview. For the impact of relationship, see Robert R. Wott v Commr., TC Memo 1986-319 and Robert Moore v U.S., 78 AFTR 2d 96-5501.
- 26 IRC Section 262.
- 27 Reg. Section 1.274-2(d)(4).
- 28 Michael P. Nammack v Commr., 56 TC 1379.
- 29 IRC Section 262; Private Letter Ruling 8124144.
- 30 IRC Section 3306(c)(5).
- 31 (\$6,000 x 2.9 percent) – (\$6,000 x 2.9 percent x 50 percent x 60 percent after-tax benefit).
- 32 IRC Sections 105(h)(8); 318(a); 414(b); 414(c); 414(m); 414(m)(6)(B); 1563(a); 1563(e)(5).
- 33 *Health Insurance Deductibility for Self-Employed Individuals*, ISP Materials, Settlement Guidelines, All Industries, January 25, 2001.
- 34 *Ibid.*
- 35 *Ibid.*
- 36 29 CFR Section 2510.3-3(b).
- 37 29 CFR Section 2510.3-3(d) explains when a participant is covered by the plan. See 29 CFR Section 2520.102 for style, format, and content requirements.
- 38 I.e., Line 14 of Schedule C for the proprietorship; see p. C-5 of the 2008 Instructions for Schedule C.
- 39 29 CFR 2520.104-20; Instructions for Form 5500 (2007), p. 4.
- 40 IRC Section 410(a)(3) defines a year of service under Reg. Section 1.105-11(c)(2)(iii)(A).
- 41 Reg. Section 1.105-11(c)(2)(iii)(A).
- 42 *Ibid.*
- 43 Reg. Section 1.105-11(c)(2)(iii)(B).
- 44 Reg. Section 1.105-11(c)(2)(iii)(C).

ship, then the facts and circumstances will determine whether this is a deductible interview. For example, say you and this woman interview for an hour and then wine and dine for three days—forget the deduction. ■

Dinner with Husband

My husband and I are in two different businesses. We often have dinner out. About one-third of the time when dining out, we discuss how to make our businesses work better and we share prospect and client names. May we deduct the cost of the dinners when we discuss business and/or trade referrals? (W.R., Orlando, Fla.)

No. The law gives you no support for such a deduction. Moreover, the law contains clear rules that work against you.

First, you may not deduct personal, family, or living expenses.²⁶ A husband and wife at dinner with no third-party prospect, client, or other business guest present is a personal living expense.

If the deductible entertainment of a third-party business guest includes your closely connected spouse, you may deduct the cost of your spouse's presence at this entertainment.²⁷ In this case, the regulations consider the fact that a third party is present.

Think of it this way: In many parts of the tax law, husband and wife are treated as one person. When you discuss business with your husband, it is like talking to yourself.

When you go to dinner by yourself, you may not deduct the cost unless you are in travel status. ■

Dependent Care Credit

I operate a successful sole proprietorship. I just learned that my wife and I will not qualify for the child and dependent care credit because my wife has no earned income. She is a stay-at-home mom taking care of our three young children. However, whenever I entertain a prospect and his or her spouse, it is critical that my wife come with me. May I deduct as a business expense the child care cost that I incur to bring my wife with me to these entertainment functions? (C.C., Knoxville, TN)

Absolutely not! Prior to the enactment of the individual tax benefit for child care more than 50 years ago, the courts held that child care was a nondeductible personal, family, and living expense.²⁸ Thus, you can qualify for the child care credit as a personal tax benefit, but not as an individual business deduction in your proprietorship.²⁹

The only way for you and your wife to qualify for the credit on two or more children is for both you and your wife individually to have more than \$6,000 of earned income.

You could hire your wife to work in your proprietorship and give her sufficient work to earn \$6,000. In your tax bracket, this would produce a \$1,200 tax credit for the child and dependent care credit. However, this hiring will also trigger FICA and Medicare taxes of 7.65 percent. This will cost *your wife* \$459. Further, it will cost *your proprietorship* \$459, but your proprietorship gets a tax deduction for this payment, making the net after-tax cost to you in your 40 percent tax bracket \$275.

Planning note. Wages paid by husband to wife or by wife to husband are exempt from federal unemployment taxes.³⁰ In general, state unemployment taxes mirror

the federal law and exempt wages paid by one spouse to the other. Thus, we need consider only the FICA and Medicare impact.

Should you hire your spouse, you claim a business deduction for the \$6,000 and your spouse pays taxes on the \$6,000. On your joint tax return, this is a wash.

However, you do benefit as a sole proprietor by the net after-tax reduction in business income subject to the Medicare tax. (Your income puts you over the 15.3 percent self-employment tax; therefore, your benefit is limited to the 2.9 percent Medicare tax that applies in your self-employment category. Fifty percent of your Medicare tax is deductible. Your net after-Medicare-tax benefit on the \$6,000 in wages you pay your spouse is \$122.³¹)

Let's take these numbers and put them together. Should you hire your wife and pay her a legitimate wage of \$6,000,

- you and your wife can qualify for a dependent care tax credit of \$1,200;
- your wife pays FICA and Medicare taxes of \$459;
- you pay FICA and Medicare taxes that, after deductions, cost you \$275; and
- you pocket \$122 in after-tax Medicare taxes because the wages you pay your wife reduce your business income.

In summary, hiring your wife so that you and she can realize the child and dependent care credit gives you \$588 in after-tax cash. Based on the ages of your children, you have 10 years when you can qualify for the child and dependent care credit, which would give you a total of \$5,880 in after-tax cash. ■

In coming issues

- Maximum benefits from the real estate closing statement
- Who is filing your 5500?
- Travel checklist