

HASHEM and SIMMS, PLLC
CERTIFIED PUBLIC ACCOUNTANTS

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August 2007

Dear Client,

We understand that you are considering providing some form of entertainment during a meeting you are having with several of your clients and you are concerned as to whether the entertainment costs you incur will be deductible. The purpose of this letter is to explain to you the general rules regarding the deductibility of entertainment expenses.

You may deduct the ordinary and necessary expenses you incur for entertainment in the pursuit of business or in connection with the production of income. The term entertainment includes various forms of recreation, amusement, food, and beverages. You cannot deduct any expenses if they are personal, family, or living expenses. Any business entertainment expense, in order to be deductible, must meet both the general requirements for business expenses and avoid the entertainment disallowance rules. These disallowance rules do not permit the deductibility of expenses that are otherwise not deductible under the Code.

Under the entertainment disallowance provisions, an entertainment expense that satisfies the ordinary and necessary requirements must still meet business connection requirements and special substantiation requirements. The business connection requirements disallow a business entertainment expense unless you prove that the costs are directly related to your business or that they are associated with the business if it directly precedes or follows a substantial business discussion.

You can prove that an entertainment expense is directly related to your business by satisfying either of two tests. The first test is whether the entertainment occurs during an active business discussion. To satisfy this test, you must meet four requirements: (1) you must have more than a general expectation of deriving a business benefit other than goodwill; (2) during the entertainment period, there must be a business meeting or a bona fide business transaction; (3) the principal character of the meeting must be business; and (4) expenses of a nonbusiness guest are not deductible. The second test is whether the entertainment occurs in a clear business setting directly in furtherance of your business. This test is objective and is likely to be met where there is no meaningful personal or social relationship between the taxpayer and the entertainment guest.

The other method to prove that there exists a business connection is if the entertainment was associated with the active conduct of your business and the entertainment directly preceded or followed a substantial and bona fide business discussion. This test allows you to deduct entertainment expenses even though no business is actually discussed during the entertainment. As a result, goodwill entertainment can be deducted under this method.



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There are several statutory exceptions to the entertainment disallowance rules. A business entertainment cost which falls within one of the exceptions is deductible if it is ordinary and necessary and for the active conduct of your business. Some of these exceptions, stated generally, are: (1) food and beverages for employees; (2) entertainment expenses treated as compensation; (3) reimbursed employee expenses; (4) recreational activities for employees; (5) business meetings; and (6) meetings of business leagues.

In addition to satisfying the above tests, IRS regulations require taxpayers to substantiate their entertainment expenses. In general, taxpayers must maintain documentary evidence (such as receipts) for all lodging expenses and, effective for all entertainment expenses of \$75 or more. I trust you have found this letter helpful in outlining the rules pertaining to the deductibility of entertainment expenses. If you have any questions, please feel free to contact us.

Sincerely,

George K Hashem

Tyler W Simms



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