

Are You Accounting for Your Entertainment Facilities Correctly?

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Are you thinking of buying a private jet? Has your company recently purchased a beach condominium? As the hedge fund industry grows larger, many more successful companies are buying items such as private jets, yachts, beach houses, ski lodges and other facilities for customer and employee use. A question to ask, however, is if companies are accounting for these items correctly for U.S. tax reporting purposes.

All of the above mentioned facilities are considered "entertainment facilities." These types of facilities are subject to the disallowance rules of Internal Revenue Code Section 274 and, therefore, require special accounting and stringent substantiation requirements. An "entertainment facility" refers to any real or personal property used for entertainment, recreation or amusement. It also includes property that is leased, or intangible property such as hunting rights. The tax court has ruled, however, that the property is only considered an entertainment facility if the taxpayer has exclusive use of the property during the recreation or entertainment.

Section 274 supplements the "ordinary and necessary" condition for business expenses and requires that most entertainment costs either be "directly related to," or "associated with," the active conduct of the taxpayer's trade or business. Typically considered to be a strict disallowance rule, under Section 274, any use of a property for entertainment purposes, no matter how minimal, results in the property being considered an entertainment facility. As a result, no deduction is generally allowed for any expenditures relating to owning, leasing or operating the facility. Furthermore, a loss on the sale of such property would also be disallowed. There are a few exceptions to this general rule.

Exception: Out-of-Pocket Expenses

Taxpayers are allowed to deduct out-of-pockets costs incurred while "entertaining" at an entertainment facility, as long as the costs are not operating costs of the facility. In order to deduct these entertainment costs, the expenditures must first satisfy the general rules of

Section 274, and the costs must meet the following criteria:

- the expenses are incurred for business purposes with the intent to receive a business benefit;
- the expenses are customary in the taxpayers' trade or business;
- the expenses are "directly related to," or "associated with," the active conduct of the taxpayers; trade or business; and
- under the circumstances, the expenses are not lavish or extravagant.

If these criteria are not met, then no deduction will be allowed for the entertainment costs incurred at the entertainment facility. Taxpayers must also demonstrate that the expenditures are ordinary, necessary and reasonable in connection to their trade or business.

For example, if a client is being entertained with dinner on the company yacht, and the dinner expenses meet the four criteria above, the cost of the dinner would not be disallowed merely because it occurs on the yacht.

If the out-of-pocket costs are permitted under this exception, they are still subject to the normal percentage limitations. For example, unless subject to specific exclusions, the costs of meals and business entertainment will be limited to 50% of their total amount. This can greatly affect the amount of the deduction taxpayers can take for entertainment expenses at their entertainment facilities.

Exception: Non-Entertainment Use

Expenditures related to certain facilities may be for non-entertainment purposes, and thus are not subject to the limitations. For example, taxpayers can deduct expenses, such as the costs of operating an automobile or airplane, if those expenses are incurred for business transportation purposes.

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Exception: Expenses Otherwise Deductible

Costs otherwise deductible without regard to a business purpose are not affected by the entertainment facility rules. For example, if a taxpayer owned a hunting lodge, items such as property taxes and mortgage interest payments attributable to the property would be deductible, regardless of the entertainment facility rules. A loss of the property due to a casualty would also follow the normal casualty loss rules.

Exception: Expenses Treated as Compensation

If the amount of the expense is reported as compensation to the recipient of the entertainment, then the taxpayer will be able to deduct the expense. Taxpayers should be mindful, however, that the amount they deduct in expenses matches the amount of income the recipient reports on his individual income tax return. For example, if an employee travels on a non-business flight on a company aircraft, the company can deduct costs associated with the flight, but only to the extent that the flight is included in the employee's compensation.

Prior to the enactment of the American Jobs Creation Act of 2004, if an individual used a company owned aircraft for personal entertainment purposes, the company could deduct all of the costs associated with the flight as long as the fair market value of such flight, which was generally significantly less than the associated costs, was included in compensation to the individual. Congress has since addressed this discrepancy, and under current law, the deductible costs to the company are limited to the value included in the individual's compensation.

Exception: Expenses for Employees

If a company provides the use of a facility, such as an on-site gym, for its employees, then expenses related to the facility will be deductible and not subject to the entertainment facility rules. Any such facility must be primarily used for the benefit of non-highly compensated employees. Taxpayers should note that substantiation is still required and that records must be kept indicating that the expenses were for activities primarily benefiting employees. No deduction will be allowed if

the activities primarily benefit officers, shareholders or highly compensation individuals. Taxpayers should also be aware that club dues are nondeductible under all circumstances.

Substantiation Requirements

Strict substantiation requirements must be adhered to in order to deduct any of the costs related to an entertainment facilities under these exceptions. Adequate records or sufficient evidence must be retained. This effectively means that logs must be kept detailing various items regarding the expenses, including, but not limited to, the amount of any out-of-pocket expenses expense, the date or time in which the facility was used, the business purpose associated with the use of the facility, and the business relationship to the taxpayer of the persons using the entertainment facility.

Taxpayers should note that mere estimates of the costs and use of entertainment facilities are not satisfactory. Additionally, if the taxpayer fails to satisfy the above substantiation records, then no deduction will be allowed.

The above summary briefly describes the basic tax rules associated with entertainment facilities under Section 274. The rules governing Section 274 are complex; accordingly, we suggest that each taxpayer consult his or her tax or legal advisor for more information concerning how these disallowance rules may affect his or her circumstances. ©

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