

Do You Have What It Takes to Deduct Your Holiday Parties?

This article gives you the knowledge you need to deduct your holiday party. The deduction depends on two factors: First, whom did you invite to the party?

Second, what did you do at this party?

The "whom" and "what" are intertwined, so that's the way we will discuss them in this article.

Employees

The cost of a holiday party for your employees is automatically deductible. No business meeting need occur. No business activity need occur.

Further, this party is not subject to the 50 percent cut that applies to entertainment expenses. Thus, make sure that your chart of accounts or other tax records contain a classification for entertainment that's 100 percent deductible.

Spouses of Employees

You may allow your employees to bring their spouses to the holiday party. You deduct the cost of entertaining the spouses just as you deduct the cost of entertaining the employees. Thus, a holiday party for employees and their spouses is 100 percent deductible.

Documentation of the Employee Party

You do not need a business reason to deduct the cost of a holiday party that is primarily for the benefit of employees.

Because the party is 100 percent deductible, you should enter the cost of the party in a category other than entertainment, because entertainment gets cut by 50 percent once it arrives on your tax return. A simple category name to use is "100 percent deductible entertainment."

To prove your deduction, you should document the names of the employees and spouses who attended the party. Plus, you should have both receipts and canceled checks to prove your expenditures. There are no limits on this deduction other than the standard requirement that the expenses may not be lavish and extravagant. (It is almost impossible for you to be denied a deduction to the "lavish and extravagant" rule.)

What If All Employees Are Family Members?

What if your only employees are your two children and your spouse? Would the holiday party be deductible? No!

Under ownership attribution rules that apply to entertainment expenses, the law deems that your ownership interest applies equally to your spouse and children. Thus, if you own 100 percent of the business, so do your children and your spouse.

In effect, you and your spouse and your children have become one person, and this one person is the owner. This one person may not go out and party alone and deduct the cost.

Losing an entertainment deduction because of this attribution rule has no effect on your other employment deductions. For example, the attribution rule has no effect on the wage deduction for the wages you pay your children. Similarly, the attribution rules do not affect your Section 105 medical plan reimbursements to your spouse.

Inviting Customers or Patients

Dr. Robert Bussabarger operated a medical practice. He gave a Christmas party for 150 people—one-third were employees.

The court held that Dr. Bussabarger could deduct only the one-third of his Christmas party that applied to employees and that he could not deduct the two-thirds that pertained to patients, friends, and neighbors.

To deduct the cost of having patients, customers, prospects, and friends to your holiday party, you must prove that your party is either

- directly related to the active conduct of your business, or
- associated with a directly related discussion that preceded or followed the party.

This requires some effort, as you will learn in a moment. In addition to the extra effort, the law subjects these deductions to the normal entertainment cut, which means your actual deduction equals only 50 cents on the dollar.

Example. If you have 50 employees and 100 customers in attendance at your tax-deductible holiday party, you divide the cost of the evening as one-third to employees and two-thirds to customers. Then, you

- deduct one-third of the cost as entertainment that is 100 percent deductible, and
- deduct two-thirds as regular entertainment.

Spouses of Customers and Patients

If you don't have a business relationship with both husband and wife, then you need a business reason to invite the spouse. A practical business reason for inviting the spouse to the holiday party is that if you don't invite both husband and wife, you substantially reduce your attendance.

What makes spouse attendance deductible? The "closely connected" rule.

Under this rule, you establish an entertainment deduction with your business contact. Then, because of this deduction, you may deduct the cost of entertaining the closely connected person (the spouse). As an additional benefit, you also may deduct the cost of your own spouse's attendance at this event.

Party Trouble

The very nature of a holiday party can make trouble for your directly related business discussion or business environment because

- the presence of cocktails creates a setting presumed to be social, and
- having the party in your home removes the natural business environment of a party in your office.

Fixing the Trouble

Keep in mind that the trouble is caused by your customers, patients, friends, and neighbors, not by your employees.

You increase your chances of your entertainment deductions when you make your holiday party an event directly

related to the active conduct of your business. You can make your home a clear business setting for the holiday party when you

- let attendees know that you are directly furthering your business by having this party,
- display your products,
- discuss your products, and
- have as your clear purpose the generation of new business rather than goodwill.

Example. You sell real estate for a living. On a bulletin board near the bar, you post photos and descriptions of eight properties currently for sale. You discuss the properties with anyone who has questions. The bulletin board display establishes a clear business setting and sets the stage for making your holiday party deductible.

With no bulletin board or other display of products, you must discuss future business with your guests to make sure you qualify for the deduction. In other words, if you choose not to have a display of some type, you need to have a directly related business discussion with each customer or patient, friend, and neighbor so that the party itself qualifies as associated entertainment.

Thus, to make deductible the cost of the nonemployees, you have two choices:

1. Make the party a business setting, or
2. Discuss business with the attendees.

If you have the holiday party in your office, you automatically meet the business setting rule.

Key Thoughts

You may deduct the cost of your holiday party when

- the cost is not lavish or extravagant;
- you meet the "directly related" or "associated" standard for business guests and prospects;
- you include employees;
- you make a proper allocation of costs to business guests, employees, and personal guests; and
- there are receipts, invoices, canceled checks, and charge card slips to verify the things you bought and support the monies you spent.

Independent Contractors

For purposes of the holiday party rules, treat your independent contractors the same as you do your customers. They do not qualify as employees for entertainment purposes.

The Presentation Exception

In general, making a presentation at your holiday party will not trigger the 100 percent deductible presentation rule, because you will fail the "general public" test. For the most part, the presentation deduction is available at a show-and-tell and try-to-sell presentation to prospects with whom you have no personal relationships (i.e., the general public).

Document Your Party

To support your deduction, your first step is to have a list of guests.

For employees and their spouses, the employees' names give you the business reason for the party. You still need receipts and other documentation as explained later, but the names of the employees and their spouses take care of the business reason.

To deduct the cost of the party attributable to patients, customers, independent contractors, friends, and neighbors, you must have either

- a directly related business discussion related to the active conduct of your business in a clear business setting, or
- associated entertainment that follows or precedes a bona fide business discussion.

To make this work with the least amount of effort, incorporate group discussion that will help move your business or practice forward.

A good practice is to include your active business pursuit in your invitation, with wording like "Please come for holiday cheer and to help us celebrate 15 years in business."

Another good practice is to take photos of attendees viewing that bulletin board covered with your product brochures. Candid shots are excellent because they illustrate business action.

You might want to forget about having individual conversations with each guest in attendance at the party. This is way too hard because you have to record each conversation. If each is different, you could spend a lot of time writing.

The bulletin board is great proof. You add substantial additional proof if you offer a toast or, better yet, a short speech on how your business can benefit those in attendance. You might mention that the attendees can also help their friends by referring them to you. If you make your formal comments from a written outline, keep the outline in your tax file. If you make the comments off the cuff, record them and throw the recording in your tax file or, better yet, have it transcribed immediately.

Do not deduct the costs attributable to those friends and relatives who are not in attendance for business reasons. For example, say you have 30 people at the party, and three are relatives who will not produce any business benefit for you. Treat 10 percent of the costs (three of 30) as nondeductible personal expenses.

Proving Costs

Although you don't need receipts for entertainment expenses of less than \$75, you always are better off with the receipts. Thus, try to have receipts for all costs of the party. If you bought both business and personal items at the same store and those items appear on the same receipt, no problem—simply circle the business items for deduction.

Keep in mind that the receipts show what you bought. You also need to prove that you paid for the items. Excellent proof of payment includes

- a canceled check,
- an ATM receipt, or
- a credit card receipt.

It's possible when you charge a purchase to a credit card that you will get a credit card purchase receipt and a purchase invoice. Keep both. Under tax law, the credit card receipt or statement proves payment and the invoice shows what you purchased.