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Tax Enlightenment

Can Employees Deduct Meals and Gifts for Co-Workers?

By: Ke Huang, *MST Student*

Many individuals may be interested in the tax treatment of expenses related to business. Some employees are required or encouraged by their employers to pay out-of-pocket for some expenses related to business. Sometimes, employees can obtain reimbursement from the company, but there are times when they are not entitled to such reimbursement based on company policy. When employees cannot be reimbursed, they may wonder whether they can deduct such expenses from their gross income when they file their tax return.

In general, all the ordinary and necessary expenses, paid or incurred during the tax year in carrying on any trade or business, are deductible. Employees may have deductible business expenses, but they must itemize their deductions (rather than claim the standard deduction). However, no deduction is allowed for personal, living or family expenses. The key to whether employment-related expenses are deductible is to determine whether the expenses are ordinary and necessary ones. In addition, there are some limitations on certain expenses. For example, deductions for client gifts are limited to \$25 each.

Let us start with an example which is not uncommon today. Jane is employed as a manager in a company and twenty people report to her. In order to keep morale high and maintain good relationships within the whole department, she usually gives a \$20 gift to her staff members on their birthdays, and she also buys a birthday cake for everyone to enjoy. However, according to company policy, only the cost of gifts to clients can be reimbursed. Jane wonders whether she can get some deduction on her personal tax return since she cannot get reimbursement from the company. After all, the purpose of providing the gifts and cakes to her staff is to help morale and improve productivity, which, she believes, are related to business and therefore should be considered business expenses.

Unfortunately for Jane, several court cases¹ have held that if providing gifts to employees or incurring expenses is not required by the employer, such expenditures are not considered ordinary and necessary business expenses. Even though these expenditures may have contributed to maintaining morale of her subordinates, there are no direct business benefits for Jane, and the gifts were not a condition of her employment. Therefore, the gifts and cakes are not deductible as they are really personal expenditures.

Now, let's move on and take a look at a similar situation: hosting an occasional dinner party or holiday party for co-workers, along with their spouses. Consider Bob, a salaried employee at a

¹ Such as *Dunkelberger*, TC Memo 1992-723, and *Fountain*, 59 TC 696 (1973).

company. He believes dinner parties and holiday parties will connect department employees more closely and will motivate them to work harder, so he often invites his subordinates to dinner parties. Similar to Jane's situation, his employer only reimburses expenses for entertainment of clients, not employees. Bob is also wondering whether he can claim a deduction on his tax return. Once again, the answer is no. The possibility of some business benefit to Bob's employer does not transform a personal expense of entertaining co-workers into ordinary and necessary business expenses.

Last but not the least, for expenses that employers will reimburse, it is the employee's responsibility to timely submit the receipts. If an employee fails to do so, he or she cannot deduct such expenses from his or her gross income. For example, assume an employee, Sarah, took her clients to dinner, and Sarah was entitled to reimbursement according to the policy of her employer. However, Sarah forgot to submit the receipts for reimbursement on time. Sarah may not deduct the expense on her tax return because it is really her employer's expense, not hers (because reimbursement was available).

Based on the rules described here, it is advisable for employees to consider:

- 1) Finding out from their employers which expenditures are expected of them as a condition of employment and which are reimbursable.
- 2) Submit receipts for all reimbursable expenses within the time limit required by the employer.



Employees with unreimbursed expenses that are required as a condition of their employment must also consider various rules on deductibility and documentation to be able to claim any of the expenses as part of their itemized deductions. For further information, individuals should consult a tax adviser. The IRS website provides information on employee business expenses; see topic 514 at <http://www.irs.gov/taxtopics/tc514.html>.