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BY RICH SHAVELL

Meals & Entertainment Deductibility: New Requirements & Opportunities

Before your company opens up a new cafeteria for employees or starts courting potential clients, make sure you understand the new limitations on the deductibility of certain business meals and that entertainment expense deductions are now prohibited as set forth in the *2017 Tax Cuts & Jobs Act* (TCJA). This article will examine the new requirements along with opportunities for partial deductibility of certain meal and entertainment costs, with a quick reference chart a few pages ahead.

Prior to the TCJA, regulations permitted a 50% deduction for entertainment, amusement, or recreation-type expenses, so long as taxpayers could substantiate that the expenses were "directly related to" or "associated with" trade or business.[1] Given the broad application of these tests, taxpayers were previously able to deduct recreational and loosely related activities as necessary business expenses. However, the TCJA removed the Internal Revenue Code (IRC) language that previously allowed deductions for such catch-all activities.

This now-disallowed group of activities also encompasses facilities "used in connection with [a prohibited] activity,"[2] such as social or athletic clubs. However, a 50% deduction is still allowed for business meals so long as they are not "lavish or extravagant under the circumstances."[3]

While the IRS does not provide specific examples of "lavish" or "extravagant" meals, the phrase "under the circumstances" indicates the subjectivity of these tests to be based on reasonableness, not dollar amount. For example, spending $5,000 on a meal in association with securing a $10,000 contract could be considered lavish, but this definition would likely not characterize a situation involving a $1 million contract.

Nonetheless, because of the disallowance of entertainment expenses and the continued allowance of business meals, food and beverages purchased during or in conjunction with entertainment activities must be itemized on a receipt or invoice, or altogether purchased separately from the related entertainment.[4]

Substantiation

In order to deduct a business meal, it would be insufficient for a taxpayer to merely identify a meal as business-related; similarly, submitting a calendar noting the name of the person with whom one has met would not be adequate. Taxpayers must document all present parties, the time, location, business purpose, and business relationship of all parties.[5] While not required on a tax return, if the pertinent information is not available in the event of an IRS examination, any related meal expenses could be disallowed in their entirety.

To illustrate the above requirement, consider the following example:

Contractor A is a season ticket holder to his alma mater's football team's games, taking advantage of these events to discuss business and entertain existing or prospective clients. In addition to admission, the cost of tickets includes parking, food, and drinks. Under pre-TCJA law, Contractor A could deduct 50% of the cost of tickets so long as the conditions of one of the aforementioned tests were satisfied. However, under the new law, Contractor A can no longer deduct any portion of the tickets, even that which is attributable to parking, food, and drinks, as everything is included within the tickets' cost.

Alternatively, under similar circumstances, if the cost of tickets does not include parking, food, or drinks – all of which Contractor A pays for separately from the tickets – the cost of the tickets and the entertainment-related travel remain nondeductible, while the food and drinks become 50% deductible.

Exceptions for Certain Entertainment-Type & Related Meals Deductions

Even though the TCJA eliminates the deductibility of entertainment expenses as a general group, the law does not eliminate (and thus retains) certain exceptions. The IRC still allows the deduction of entertainment-type (and related meals) expenses in nine specific instances,[6] which

can be separated into two groups: 50% deductible[7] and 100% deductible.[8]

50%-Deductible Entertainment & Related Meals

The following exceptions to the disallowance are limited to a 50% deduction:

- *Food and beverages that are provided to employees while at work* – These expenses are commonly referred to as for the "convenience of the employer," and include the cost of related facilities. Note that this category is being phased out (see below).
- *Food and beverages that are provided for employee or shareholder (or similar) meetings* – These expenses include food and beverages provided at such meetings, e.g., Contractor A's shareholder retreat to elect new officers. For such a retreat, related meals and entertainment expenses are 50% deductible, provided the primary purpose of the retreat is business-related in nature.[9]
- *For participation in and/or attendance at meetings or conventions of trade organizations* – These events include those that are held for chambers of commerce or industry-specific boards (e.g., a local CFMA chapter's monthly breakfast meeting).

Food & Beverage for the Convenience of the Employer

A notable addition to the aforementioned 50%-deductible group is food or beverages provided for the convenience of the employer. Despite its application to food and beverages (which are not generally considered entertainment), this is included in the exceptions to the disallowance of entertainment-type expenses because the exception extends to the cost of facilities used for providing food and beverage, which is normally considered entertainment in nature.

Prior to the TCJA, such expenses were 100% deductible, as the IRC provided that the 50% limitation did not apply to an expense that "is excludable from the gross income of the recipient…relating to de minimis fringes."[10] The de minimis fringe applied to food and beverage provided on the employer's premises,[11] as well as meals provided at an employer-operated facility.[12] However, the TCJA removed this provision; the deductibility of these expenses has been reduced from 100% to 50%. Moreover, the TCJA altogether completely eliminates the deduction beginning January 1, 2026.[13] These changes have been addressed by a recent IRS Notice, in which the IRS states that they intend to issue clarifying regulations.[14]

Let's consider some examples to illustrate these changes.

Contractor A provides lunch at jobsites so that its employees remain onsite in efforts to increase productivity. Under pre-TCJA law, Contractor A was able to deduct the full cost of these meals, but can now only deduct 50%. Beginning in 2026, these expenses cannot be deducted at all.

Now, consider that Engineer A operates a cafeteria at its headquarters and provides lunch for its employees. Under pre-TCJA law, Engineer A was previously able to deduct the full cost of food and beverage, in addition to the cafeteria's facility operating costs. Now, Engineer A can only deduct 50% and beginning in 2026, cannot deduct any of the expenses.

The alternative to the limitation (or disallowance, beginning in 2026) of the expenses in the preceding two examples is for businesses to include the cost of food, beverage, and related facilities in employee compensation.

However, it may not be possible for an employer to track precisely which, and how much, employees eat and drink. Would it be fair to pass on the cost of an employer-operated cafeteria to all employees, given that not all participate? Hopefully, the IRS will provide further guidance as to the implementation of such a practice and possibly establish de minimis and safe harbor thresholds.

100%-Deductible Entertainment & Related Meals

While the TCJA retains the 100% deductibility of the following six entertainment-type expenses, it is important to understand the limitations and nature of each and therefore, when these costs can be deducted in full:[15]

1) Recreational expenses for employees
2) Reimbursed expenses
3) Expenses treated as compensation to employees
4) Expenses includible in income of persons who are not employees
5) Items available to the public
6) Entertainment sold to customers

Item 1 provides the most flexibility for taxpayers, as it allows businesses to deduct entertainment expenses for the benefit of all employees. The key to this provision is that the benefit needs to be for all employees, not just officers, shareholders, or highly compensated employees.[16]

EXHIBIT 1: 100% vs. 50% vs. 0% Deductible Items*

<table>
<tr><th></th><th>Meals</th><th>Entertainment</th></tr>
<tr><td>100% Deductible</td><td colspan="2">• Recreational expenses for all employees
• Expenses treated as compensation to recipients
• Certain items available for free to the "public"</td></tr>
<tr><td>50% Deductible</td><td colspan="2">• Employee onsite food and beverages for the "convenience of the employer" (on or before 12/31/2025)
• Business meals
• Employee/stockholder business meetings
• Meetings of business leagues</td></tr>
<tr><td>0% Deductible</td><td>• Entertainment-related meals
• Employee onsite food and beverages for the "convenience of the employer" (on or after 1/1/2026)</td><td>• Club dues and memberships
• Fishing/golf/hunting trips
• Sporting events</td></tr>
</table>

In all situations there are limitations and documentation requirements. Always consult your tax advisor.

For example, the cost of an onsite fitness facility a business provides for all its employees would be fully deductible. In addition to this type of ongoing employee perk, employers are able to utilize this exception for less frequent events, such as holiday parties.

Despite these rules and the specific requirement that an activity benefits all employees to be eligible for deduction, it may not always be practical to entertain all employees at a given time. However, so long as the activity does not discriminate toward any of the previously mentioned groups of employees, employers can fully deduct the costs of recreational activities that benefit all employees, even when designed to limit the number of employees at any given time.[17]

For example, the Tax Court permitted a company to deduct the cost of chartering a powerboat for use by its employees. The activity was on a "first-come, first-served" basis, and not every employee could be accommodated.[18] The Tax Court cautioned, "We hasten to point out that, although we decide as a matter of law that a proper interpretation of section 274(e)(5) does not require in absolute terms that the recreational activities be made available to all employees without exception, provided that the selection of eligible employees is made on reasonable grounds, the application of the reasonableness criteria here depends entirely upon the facts of this case and should not necessarily be considered a precedent in other factual situations."[19]

For items 2, 3, and 4, taxpayers can only deduct entertainment expenses if someone is liable to recognize a corresponding amount of income, which is not usually practical.

For example, Contractor B is a season ticket holder at a local sports team's arena, and provides the tickets to its employees on a rotating basis. In order to deduct the cost of the tickets, Contractor B can include the cost of the tickets in its employees' Forms W-2 wages for the game that each respectively attends.

Likewise, if the tickets are provided to an independent subcontractor, Contractor B could include the cost of the tickets in the independent subcontractor's Form 1099-Misc in order to claim any tax deduction. Contractor B would have to pay FICA tax on the additional Form W-2 wages, and, in both instances, most employees and independent contractors would likely balk at the acceptance of an entertainment-type activity if it means including the cost in their taxable income.

Similar to item 1 above, item 5 allows for businesses to exercise creative flexibility in offering food, beverages, and entertainment to the general public. These expenses are often confused with advertising or promotional expenses, but more appropriately, fall under the umbrella of 100%-deductible meals and entertainment.

While this exception literally applies to any entertainment that is free and available to the public, the general applicability is to entertainment expenses that are provided as product samples or as part of sales pitches that include complimentary products for which anyone could potentially be eligible. A restriction of the complimentary products is that the "comps" must be "inside comps" as opposed to "outside comps."

For example, a homebuilder that advertises a free vacation upon closing to homebuyers can't deduct the cost of the vacations because the vacations are "outside comps," provided by a third party (the vacation vendor). However, a homebuilder that advertises complimentary home theater upgrades upon closing can deduct the cost in full because they are the provider of the "comp."[20]

Toeing a fine line between items that are free and available to the general public, businesses often host gala dinners or similar client appreciation events. Since these events are by invitation only and are thus not technically available to everyone, no deduction is allowed.

However, businesses that offer complimentary food and beverage to any potential customers, such as to prospective homebuyers on a walkthrough tour, can deduct the full cost of food and beverage. The difference between the two is that in the former, only existing clients are offered the entertainment (gala dinner); in the latter, even though the entertainment is only available to potential homebuyers, anyone can technically be a potential homebuyer.[21]

Item 6 has very narrow applicability, as it applies mostly to the cost of producing entertainment for resale to customers. As long as a business sells the entertainment to its customers for "adequate and full consideration,"[22] it can fully deduct the related costs. Again, similar to the above scenarios, someone is picking up the income.

Accounting for Meals & Entertainment

Not only will the recent law change impact businesses' taxable income, but companies must also alter their accounting procedures. Prior to the new law, most businesses accounted for both types of expense under one joint "meals and entertainment" expense account. However, under the new law, businesses will have to account for their non-deductible entertainment expenses separately from their meal and entertainment expenses by differentiating between 50%- and 100%-deductible items on their chart of accounts.

Summary

CFMs should seek future guidance on the deductibility of "convenience of the employer"-type expenses. As of 2018, it is important for CFMs to understand the exceptions permitted to overcome the total disallowance of entertainment expenses. In so doing, contractors can ensure partial or full deductions to which they are entitled. ■

Endnotes

1. *www.irs.gov/publications/p463.*
2. IRC §274(a)(1)(B).
3. IRC §274(k)(1)(A).
4. *Treas. Notice 2018-76*, 2018-42 IRB, 10/03/2018, IRC §274.
5. IRC §274(d)(3).
6. IRC §274(e)(1-9).
7. IRC §274(n)(1).
8. IRC §274(n)(2)(A).
9. Treas. Reg. §1.274-2(f)(2)(vi).
10. IRC §274(n)(2)(B) prior to amendment by §13304(n)(2)(B), PL 115-97, 12/22/2017.
11. IRC §119(a).
12. IRC §132(e)(2).
13. IRC §274(o).
14. *Treas. Notice 2018-76*, 2018-42 IRB, 10/03/2018, IRC §274.
15. IRC §274(n)(2)(A).
16. IRC §274(e)(4).
17. Treas. Reg. §1.274-2(f)(2)(v).
18. *American Business Service Corp. v. Comr.*, 93 TC 449.
19. Ibid.
20. TAM 9641005, 10/11/1996.
21. *Churchill Downs, Inc. And Subs. V. Comm.*, 90 AFTR 2d 2002-6615 (307 F3d 423), (CA6), 10/08/2002.
22. IRC §274(e)(8).

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