

# Current Federal Tax Developments

Week of February 24, 2020

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ACCOUNTING  
CONTINUING EDUCATION

CURRENT FEDERAL TAX DEVELOPMENTS  
WEEK OF FEBRUARY 24, 2020  
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# Current Federal Tax Developments

Kaplan Financial Education

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Section: Proposed Regulations Issued to Deal With Changes in Meals and Entertainment ...1



## **SECTION: PROPOSED REGULATIONS ISSUED TO DEAL WITH CHANGES IN MEALS AND ENTERTAINMENT**

### **Citation: REG-100814-19, 2/21/2020**

The Treasury Department has released proposed regulations relating to the changes to IRC §274 made as part of the Tax Cuts and Jobs Act.<sup>1</sup>

The Tax Cuts and Jobs Act (TCJA) repealed the rule that allowed a deduction for entertainment expenses if the taxpayer established that:

- The entertainment was directly related to the active conduct of the taxpayer's trade or business (*directly related exception*), or
- In the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the item was associated with the active conduct of the taxpayer's trade or business (*business discussion exception*).

Thus, following the TCJA, no deductions are allowed for entertainment expenses unless they meet one of the exceptions found at IRC §274(e).

Initially many were concerned it was not clear that meals had not been included as part of entertainment, since in prior acts Congress had treated meals as a subset of entertainment. But the IRS indicated in the preliminary guidance given in Notice 2018-76 that the agency did not believe the law barred deductions for most meals. The preamble to the proposed regulations confirm this treatment, stating:

While the TCJA eliminated the deduction for entertainment expenses, Congress did not amend the provisions relating to the deductibility of business meals. Thus, taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business, including meals consumed by employees on work travel. See H.R. Rep. No. 115-466, at 407 (2017) (Conf. Rep.). However, as before the TCJA, no deduction is allowed for the expense of any food or beverages unless (a) the expense is not lavish or extravagant under the circumstances, and (b) the taxpayer (or an employee of the taxpayer) is present at the furnishing of the food or beverages. See section 274(k).<sup>2</sup>

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<sup>1</sup> REG-100814-19, February 21, 2020, <https://docs.google.com/document/d/1G5BQic54VUc4zqPqjYcvj-cqYzftVvvkIB0tkHnqPFQ/edit> (retrieved February 21, 2020)

<sup>2</sup> REG-100814-19, February 21, 2020, p. 5

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As well, the preamble confirms what many had noticed—there was no longer anything left in §274 that required the strict substantiation provisions for meals other than those related to travel. As the preamble continues:

Prior to amendment by the TCJA, section 274(d) provided substantiation requirements for deductions under section 162 or 212 for any traveling expense (including meals and lodging while away from home), and for any item with respect to an activity of a type considered to constitute entertainment, amusement, or recreation or with respect to a facility used in connection with such activity. Section 13304(a)(2)(A) of the TCJA repealed the substantiation requirements for entertainment expenditures. Traveling expenses (including meals and lodging while away from home), however, remain subject to the section 274(d) substantiation requirements. Food and beverage expenses are subject to the substantiation requirements under section 162 and the requirement to maintain books and records under section 6001.<sup>3</sup>

Note that this doesn't mean there is no substantiation required, but rather that the anti-*Cohan* rules of old IRC §274(d) no longer apply. So a taxpayer can now attempt to use the *Cohan* case to argue for a deduction for meals not related to travel even if there is minimal substantiation—but it is important to note that such attempts most often fail, due to a lack of evidence to enable a reasonable estimate for expenses in the past that have been eligible for the *Cohan* treatment.

The preamble also discusses the removal of the ability of employers to claim 100% of the amount paid for *de minimis* food and beverage fringes, instead subjecting them to the 50% disallowance rule of IRC §274(n)(2)(B). The preamble states:

Prior to amendment by the TCJA, section 274(n)(1) generally limited the deduction for food or beverage expenses to 50 percent of the amount that otherwise would have been allowable, subject to an exception in section 274(n)(2)(B) in the case of an expense for food or beverages that is excludable from the gross income of the recipient under section 132 by reason of section 132(e), relating to *de minimis* fringes. Section 132(e)(1) defines “*de minimis* fringe” as any property or service the value of which is, after taking into account the frequency with which similar fringes are provided by the employer to its employees, so small as to make accounting for it unreasonable or administratively impracticable. Section 132(e)(2) provides that the operation by an employer of any eating facility for employees is treated as a *de minimis* fringe if (1) the facility is located on or near the business premises of the employer, and (2) revenue derived from the facility normally equals or exceeds the direct operating costs of the

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<sup>3</sup> REG-100814-19, February 21, 2020, p. 5

facility. Thus, under prior law, employers generally were allowed to fully deduct an expense for food or beverages provided to their employees if the amount was excludable from the gross income of the employee as a de minimis fringe. However, the TCJA repealed section 274(n)(2)(B), meaning that expenses for food or beverages that are *de minimis fringes* under section 132(e) are no longer excepted from section 274(n)(1). As a result, these expenses, like other food or beverage expenses generally, are subject to the 50 percent limitation unless one of the six exceptions to section 274(n) in section 274(e) applies.<sup>4</sup>

Some meals are allowed in full based on the exceptions found in IRC §274(e). Specifically, the preamble notes the following exceptions to the 50% disallowance of amounts paid for meals:

- Expenses for goods, services, and facilities to the extent that the expenses are treated as compensation to the recipient.<sup>5</sup>
- Expenses incurred by a taxpayer in connection with the performance of services for an employer or other person under a reimbursement or other expense allowance arrangement.<sup>6</sup>
- Expenses for recreational, social, or similar activities for employees.<sup>7</sup>
- Expenses for goods, services, and facilities made available to the general public.<sup>8</sup>
- Expenses for goods or services that are sold by the taxpayer in a bona fide transaction for adequate and full consideration in money or money's worth.<sup>9</sup>
- Expenses for goods, services, and facilities to the extent that the expenses are treated as income to a person other than an employee.<sup>10</sup>

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<sup>4</sup> REG-100814-19, February 21, 2020, pp. 7-8

<sup>5</sup> IRC §274(e)(2)

<sup>6</sup> IRC §274(e)(3)

<sup>7</sup> IRC §247(e)(4)

<sup>8</sup> IRC §274(e)(7)

<sup>9</sup> IRC §274(e)(8)

<sup>10</sup> IRC §274(e)(9)

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The proposed regulations would add two new regulations under IRC §274. Those regulations would be:

- Reg. §1.274-11: Dealing with entertainment expenditures paid or incurred after December 31, 2017 and
- Reg. §1.274-12: Dealing with food or beverage expenses under IRC §274(k) and §274(n) paid or incurred after December 31, 2017, including the application of the various exceptions under IRC §274(e) and business meals described in Notice 2018-76, as well as other meals including travel meals and employer provided meals.<sup>11</sup>

### ***Entertainment Expenditures (Proposed Reg. §1.274-11)***

The basic issue here is simple—no deduction is allowed, except as provided for in IRC §274(e), for

- Any entertainment expenditure,
- Expenditures related to a facility used in connection with an entertainment activity (including dues or fees paid to any social, athletic or sporting club or organization); or
- Amounts paid or incurred for membership in any club organized for business, pleasure, recreation or other social purpose.<sup>12</sup>

But the question is what exactly do those terms mean? Proposed Reg. §1.274-11(b) provides specific definitions for various terms.

### ***Entertainment***

Obviously, a key term to define is that of *entertainment*. The regulation defines entertainment generally as:

...any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family.<sup>13</sup>

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<sup>11</sup> REG-100814-19, February 21, 2020, pp. 9-10

<sup>12</sup> Proposed Reg. §1.274-11(a)

<sup>13</sup> Proposed Reg. §1.274-11(b)(1)(i)



The proposed regulation then goes on to describe three specific modifications to this definition:

- The described activities are treated as entertainment under this section, subject to the objective test, regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. Basically, you can't get around this rule by arguing the expenditure is otherwise an ordinary and necessary business expense, the broad rule applicable to most business expenses found at IRC §162. IRC §274 is a specific set of exceptions to the general rule found at IRC §162.
- The term *entertainment* may include an activity, the cost of which otherwise is a business expense of the taxpayer, which satisfies the personal, living, or family needs of any individual, such as a hotel suite or an automobile to a business customer or the customer's family. Thus, context is extremely important when evaluating an expenditure, not just the specific expenditure itself.
- Finally, the regulation limits the reach of *entertainment* by excluding activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as a hotel room maintained by an employer for lodging of employees while in business travel status or an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. But the regulation notes that the providing of a hotel room or an automobile by an employer to an employee who is on vacation would constitute entertainment of the employee.<sup>14</sup>

### *Food and Beverages*

Food and beverages are not considered entertainment unless they are provided during or at an entertainment activity.<sup>15</sup> But even food provided during or at an entertainment activity may escape classification as entertainment. The regulation provides:

...[I]n the case of food or beverages provided during or at an entertainment activity, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.<sup>16</sup>

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<sup>14</sup>Proposed Reg. §1.274-11(b)(1)(i)

<sup>15</sup> Proposed Reg. §1.274-11(b)(1)(ii)

<sup>16</sup> Proposed Reg. §1.274-11(b)(1)(ii)

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The “separate billing” rule first appeared in Notice 2018-76 and that basic rule is repeated in the proposed regulation. To meet the separate billing requirement the regulation provides:

The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue’s usual selling cost for those items if they were to be purchased separately from the entertainment, or must approximate the reasonable value of those items. Unless the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation can be made and the entire amount is a nondeductible entertainment expenditure.<sup>17</sup>

### *Objective Test*

Knowing that taxpayers and advisers would look long and hard for ways to claim their expenditure is different the IRS issues what the agency refers to as an *objective test*. Note that, in fact, the test is a subjective test, but one that the IRS is presumed to be correct in applying during an exam. The objective test provides:

An objective test is used to determine whether an activity is of a type generally considered to be entertainment. Thus, if an activity is generally considered to be entertainment, it will be treated as entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments that entertainment means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer’s trade or business is considered. Thus, although attending a theatrical performance generally would be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in a professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce its products to a group of store buyers, the show generally would not be considered entertainment. However, if an appliance distributor sponsors a fashion show, the fashion show generally would be considered to be entertainment.<sup>18</sup>

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<sup>17</sup> Proposed Reg. §1.274-11(b)(1)(ii)

<sup>18</sup> Proposed Reg. §1.274-11(b)(1)(iii)

The regulation reminds the reader that the exceptions under IRC §274(e) override the bar on the deduction of entertainment expenses.

### *Examples*

As with most regulations, the language of the regulation text only provides some clues about how the IRS is likely to approach specific situations. The examples that often accompany the regulations are important for the adviser to study to gain an insight in how the IRS expects to apply the specifics discussed in the regulations.

The four examples below apply the entertainment provisions of Proposed Reg. §1.274-11 to some situations encountered by taxpayers. In each of the examples neither the taxpayer nor the business associate is engaged in a trade or business that relates to the entertainment activity

#### **EXAMPLE 1, PROPOSED REG. §1.274-11(D)(1) – A BASEBALL GAME**

Taxpayer A invites B, a business associate, to a baseball game to discuss a proposed business deal. A purchases tickets for A and B to attend the game. The baseball game is entertainment as defined in paragraph (b)(1) of this section and thus, the cost of the game tickets is an entertainment expenditure and is not deductible by A.

Now we modify the example to consider the case where the taxpayer buys hot dogs and drinks for himself and the associate once they are at the game:

#### **EXAMPLE 2, PROPOSED REG. §1.274-11(D)(2) – THE HOT DOGS AND DRINKS**

Assume the same facts as in paragraph (d)(1) of this section (Example 1), except that A also buys hot dogs and drinks for A and B from a concession stand. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expenditure and is not subject to the section 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game if they meet the requirements of section 162 and §1.274-12.

Now we look at the case where the taxpayer has access to a luxury suite for a basketball game where food and beverages are provided in a bundle covered by a single fee:

#### **EXAMPLE 3, PROPOSED REG. §1.274-11(D)(3)-HOT DOGS AND DRINKS AT THE SUITE**

Taxpayer C invites D, a business associate, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food or beverages. The basketball game is entertainment as defined in paragraph (b)(1) of this section and, thus, the cost of the game tickets is an entertainment expenditure and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages is an entertainment expenditure that is subject to the section 274(a)(1) disallowance. Therefore, C

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may not deduct the cost of the tickets or the food and beverages associated with the basketball game.

The answer changes when the food and beverage are separately stated on the invoice.

### **EXAMPLE 4, PROPOSED REG. §1.274-11(D)(4), FOOD AND DRINKS SEPARATELY STATED ON INVOICE**

Assume the same facts as in paragraph (d)(3) of this section (Example 3), except that the invoice for the basketball game tickets separately states the cost of the food and beverages and reflects the venue's usual selling price if purchased separately. As in paragraph (d)(3) (Example 3), the basketball game is entertainment as defined in paragraph (b)(1) of this section and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expenditure and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expenditure and is not subject to the section 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game if they meet the requirements of section 162 and §1.274-12.

Note that these four examples are essentially the same examples, with the same results, as were found in Notice 2018-76.

### ***Food or Beverages (Proposed Reg. §1.274-12)***

The existing regulations under §274 did not always clearly differentiate between entertainment and meals. Now that the IRS has determined that the law Congress enacted does actually treat meals differently than entertainment, a comprehensive regulation on food and beverages is required, found at Proposed Reg. §1.274-12.

This regulation also contains the explanations of the exceptions found at IRC §274(e) that impact food and beverages.

The regulation begins with three rules that must be met in order for any deduction to be allowed for the provision of food and beverages as part of a business meal:

- The expense is not lavish or extravagant under the circumstances;
- The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
- The food or beverages are provided to a business associate.<sup>19</sup>

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<sup>19</sup> Proposed Reg. §1.274-12(a)(1)

Unless a specific exception applies, only 50% of the amount expended for food and beverages will be allowed as a deduction.<sup>20</sup>

The IRS provides two simple examples to illustrate these rules. In neither case were the expenditures lavish or extravagant under the circumstances.

The first example is the traditional lunch with a client or customer.

**EXAMPLE 1, PROPOSED REG. §1.274-12(A)(3)(I), TAKING A CLIENT TO LUNCH**

Taxpayer A takes client B out to lunch. While eating lunch, A and B discuss A's trade or business activities. Under section 274(k) and (n) and paragraph (a) of this section, A may deduct 50 percent of the food or beverage expenses.

Similarly, a lunch with an employee for a business purpose is also fine.

**EXAMPLE 2, PROPOSED REG. §1.274-12(A)(3)(II), EMPLOYEE' PERFORMANCE REVIEW**

Taxpayer C takes employee D out to lunch. While eating lunch, C and D discuss D's annual performance review. Under section 274(k) and (n) and paragraph (a) of this section, C may deduct 50 percent of the food and beverage expenses.

Meals incurred while on travel will remain subject to the substantiation rules of IRC §274(d).<sup>21</sup> Since §274(d) applies, the taxpayer must have the following in order to claim a deduction for meals incurred while traveling:

- The amount of such expense or other item,
- The time and place of the travel or the date and description of the gift,
- The business purpose of the expense or other item, and
- The business relationship to the taxpayer of the person receiving the benefit.<sup>22</sup>

Travel meal expenses of a spouse, dependent or other individual accompanying the taxpayer are not allowed unless the following criteria are met:

- The spouse, dependent, or other individual is an employee of the taxpayer;
- The travel of the spouse, dependent, or other individual is for a bona fide business purpose of the taxpayer; and

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<sup>20</sup> Proposed Reg. §1.274-12(a)(2)

<sup>21</sup> Proposed Reg. §1.274-12(a)(4)

<sup>22</sup> IRC §274(d)

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- The expenses would otherwise be deductible by the spouse, dependent or other individual.<sup>23</sup>

Although not officially labeled as an example, the IRS provides the following illustration of the application of the accompanying individual provision.

### **ILLUSTRATION, REG. §1.274-12(A)(4)(III)(D), TRAVEL WITH SPOUSE**

Taxpayer E and Taxpayer E's spouse travel from New York to Boston to attend a series of business meetings. E's spouse is not an employee of E, does not travel to Boston for a bona fide business purpose of E, and the expenses would not otherwise be deductible. While in Boston, E and E's spouse go out to dinner. Under section 274(m)(3) and paragraph (a)(4)(iii) of this section, the expenses associated with the food and beverages consumed by E's spouse are not deductible. Therefore, the cost of E's spouse's dinner is not deductible. E may deduct 50 percent of the expense associated with the food and beverages E consumed while on business travel if E meets the requirements in sections 162 and 274, including section 274(k) and (d).

### *Food or Beverage*

The regulations provide the following definition of a food or beverage:

Food or beverages means all food and beverage items, regardless of whether characterized as meals, snacks, or other types of food and beverages, and regardless of whether the food and beverages are treated as *de minimis fringes* under section 132(e).<sup>24</sup>

Food or beverage expenditures are also defined in the regulation:

Food or beverage expenses mean the full cost of food or beverages, including any delivery fees, tips, and sales tax. In the case of employer-provided meals furnished at an eating facility on the employer's business premises, food or beverage expenses do not include expenses for the operation of the eating facility such as salaries of employees preparing and serving meals, and other overhead costs.<sup>25</sup>

### *People at the Meal or for the Exceptions*

The proposed regulation also looks at definitions for those who need to be at the meal to be deductible or to qualify for one of the exceptions under IRC §274(e).

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<sup>23</sup> Proposed Reg. §1.274-12(a)(4)(a)(iii)

<sup>24</sup> Proposed Reg. §1.274-12(b)(1)

<sup>25</sup> Proposed Reg. §1.274-12(b)(2)

The first definition is that of a *business associate*:

Business associate means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.<sup>26</sup>

Next up is the definition of an *independent contractor*:

For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, independent contractor means a person who is not an employee of the payor.<sup>27</sup>

The definition of a *client or customer* is as follows:

For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, client or customer means a person who receives services from an independent contractor and enters into a reimbursement or other expense allowance arrangement with the independent contractor.<sup>28</sup>

The *payor* is defined as:

For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, payor means a person that enters into a reimbursement or other expense allowance arrangement with an employee and may include an employer, its agent, or a third party.<sup>29</sup>

The *general public* is defined as:

For purposes of paragraph (c)(2)(iv) of this section, the general public includes, but is not limited to, customers, clients, and visitors. The general public does not include employees, partners or independent contractors of the taxpayer. Also, an exclusive list of guests is not the general public.

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<sup>26</sup> Proposed Reg. §1.274-12(b)(3)

<sup>27</sup> Proposed Reg. §1.274-12(b)(4)

<sup>28</sup> Proposed Reg. §1.274-12(b)(5)

<sup>29</sup> Proposed Reg. §1.274-12(b)(6)

### *Reimbursement Arrangement*

For some of the exceptions, a reimbursement arrangement is involved. The IRS defines a reimbursement arrangement as follows:

- An arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (the employer, its agent, or a third party) for expenses the employee pays or incurs; and
- An arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs if either--
  - A written agreement between the parties expressly states that the client or customer will reimburse the independent contractor for expenses that are subject to the limitations on deductions in paragraph (a) of this section; or
  - A written agreement between the parties expressly identifies the party subject to the limitations.<sup>30</sup>

### ***§274(e) Exceptions for Food and Beverages***

The regulation concludes with guidance on the various exceptions to the general rules found in IRC §274(e).

#### *Expenses Treated as Compensation*

One option to avoid the 50% limit is to treat food and beverage as compensation to the employee. This includes items that involve the special requirements for meals while traveling. This exception is available if the expense is treated by the taxpayer:

- On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and
- As wages to the employee for purposes of withholding under chapter 24 of the Code, relating to collection of income tax at source on wages.<sup>31</sup>

The compensation rule can apply to independent contractors in addition to employees, but an additional restriction applies. The amount in question must be included in a Form 1099 issued to the contractor if the contractor is one to whom a 1099 would be required to be issued. For this purpose, the Form 1099 must be issued even if the Form 1099 wouldn't be required to be issued because the amounts are less than \$600.

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<sup>30</sup> Proposed Reg. §1.274-12(b)(7)

<sup>31</sup> Proposed Reg. §1.274-12(c)(2)



However, if other rules eliminate the need to file it (such as the payee is a corporation), then not issuing a Form 1099 is not fatal to the deduction.<sup>32</sup>

In the preamble the IRS indicated that they were providing examples to deal with specific fact patterns that some commentators had raised concerns about.<sup>33</sup> Thus, advisers who have situations such as those addressed in the regulation's examples need to pay close attention to these examples.

The first pair of examples are found in this area where the amounts are included as compensation.

The first example deals with the provision of food to employees at a company cafeteria where the employer treats the meals as compensation and thus preserves a full deduction for the expense.

**EXAMPLE 1, PROPOSED REG. §1.274-12(C)(2)(D)(1), CAFETERIA FOOD IN THE PAYCHECK**

Employer F provides food and beverages to its employees without charge at a company cafeteria on its premises. The food and beverages do not meet the definition of a *de minimis fringe* under section 132(e). F treats the food and beverage expenses as compensation and wages, and determines the amount of the inclusion under §1.61-21. Under section 274(e)(2) and paragraph (c)(2)(i) of this section, the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitations in paragraph (a) of this section. Thus, F may deduct 100 percent of the food and beverage expenses.

But the next example notes that if the meals are excluded from the employee's wages under IRC §119 because they are provided for the convenience of the employer, the employer will have to reduce the deduction by 50% of the expense incurred.

**EXAMPLE 2, PROPOSED REG. §1.274-12(C)(2)(D)(2), MEALS EXCLUDED FROM WAGES**

Employer G provides meals to its employees without charge. The meals are properly excluded from the employees' income under section 119 as meals provided for the convenience of the employer. Under §1.61-21(b)(1), an employee must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount, if any, paid for the benefit by or on behalf of the recipient, and the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Code. Because the entire value of the employees' meals is excluded from the employees' income under section 119, the fair market value of the fringe benefit does not exceed the amount excluded from gross income under subtitle A of the Code, so there is nothing to be included in the employees' income under §1.61-21. Thus, the exception in section 274(e)(2) and

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<sup>32</sup> Proposed Reg. §1.274-12(c)(2)(ii)(B)

<sup>33</sup> REG-100814-19, February 21, 2020, p. 15

paragraph (c)(2)(i) of this section does not apply and G may only deduct 50 percent of the expenses for the food and beverages provided to employees.

### *Reimbursed Expenses*

If the service recipient is reimbursing the business related meals expenses of the service provider, one or the other party (but not both) is going to have to bear the burden of the 50% deduction disallowance.<sup>34</sup>

If the reimbursement arrangement involves an employee, the regulation provides:

- The disallowance applies to the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid to the employee and treats the amount as wages subject to withholding. Note that due to the disallowance of deductions for miscellaneous itemized deductions found in IRC §67(g) that was added by TCJA, in reality the employee will most often get no deduction for the meals expense.
- The disallowance applies to the payor if the amount is not treated as wages by the payor. However, if the payor itself is reimbursed by a customer for those meals, then we look to the rules for reimbursing persons that are not employees discussed next.<sup>35</sup>

If the reimbursement occurs to a nonemployee, such as in the case of a payment to an independent contractor, the limits apply to the party specified in the agreement as bearing the burden of the loss of the deduction, assuming such a designation is made in the contract or other arrangement.<sup>36</sup> If the agreement does not provide a designation, the deduction limit applies to:

- The independent contractor if the contractor does not account to the client or customer the amounts paid as such accounting is defined under the anti-*Cohan* rules of IRC §274(d).
- The client or customer if such an accounting is provided by the independent contractor. Such accounting will generally occur by separately stating the billing for the food and providing documentation of the same.<sup>37</sup>

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<sup>34</sup>Proposed Reg. §1.274-12(c)(2)(ii)(A)

<sup>35</sup> Proposed Reg. §1.274-12(c)(2)(ii)(B)

<sup>36</sup> Proposed Reg. §1.274-12(c)(2)(ii)(C)

<sup>37</sup> Proposed Reg. §1.274-12(c)(2)(ii)(C) and (D)

The IRS provides four examples dealing with the reimbursement rules.

**EXAMPLE 1, PROPOSED REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT**

Employee I performs services under an arrangement in which J, an employee leasing company, pays I a per diem allowance of \$10x for each day that I performs services for J's client, K, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food or beverages that I pays in performing services as an employee. J enters into a written agreement with K under which K agrees to reimburse J for any substantiated reimbursements for travel expenses, including meal expenses, that J pays to I. The agreement does not expressly identify the party that is subject to the limitations on deductions in paragraph (a) of this section. I performs services for K while traveling away from home for 10 days and provides J with substantiation that satisfies the requirements of section 274(d) of \$100x of meal expenses incurred by I while traveling away from home. J pays I \$100x to reimburse those expenses pursuant to their arrangement. J delivers a copy of I's substantiation to K. K pays J \$300x, which includes \$200x compensation for services and \$100x as reimbursement of J's payment of I's travel expenses for meals. Neither J nor K treats the \$100x paid to I as compensation or wages.

Under paragraph (b)(7)(i) of this section, I and J have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(B)(1) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Instead, under paragraph (c)(2)(ii)(B)(2) of this section, J, the payor, is subject to limitations on deductions in paragraph (a) of this section unless J can meet the requirements of section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section.

Because the agreement between J and K expressly states that K will reimburse J for substantiated reimbursements for travel expenses that J pays to I, under paragraph (b)(7)(ii)(A) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. J accounts to K for K's reimbursement in the manner required by section 274(d) by delivering to K a copy of the substantiation J received from I. Therefore, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C)(2) of this section, K and not J is subject to the deduction limitations in paragraph (a) of this section.

The IRS then changes this employee leasing example slightly. The employee now accounts for the meals expense to the customer of the leasing company, and that customer then pays the reimbursement.

**EXAMPLE 2, PROPOSED REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT BY CUSTOMER DIRECTLY TO EMPLOYEE**

The facts are the same as Example 1 except that, under the arrangements between I and J and between J and K, I provides the substantiation of the expenses directly to K, and K pays the per diem directly to I.

Under paragraph (b)(7)(i) of this section, I and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because I substantiates directly to K and the reimbursement payment was not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(C)(1) of

this section I is not subject to the limitations on deductions in paragraph (a) of this section. Under paragraph (c)(2)(ii)(C)(2) of this section, K, the payor, is subject to the limitations on deductions in paragraph (a) of this section.

Now the IRS modifies the example to provide that limits apply to the employee leasing company.

**EXAMPLE 3, PROPOSED REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT COVERED BY AGREEMENT**

The facts are the same as in Example 1 except that the written agreement between J and K expressly provides that the limitations of this section will apply to K.

Under paragraph (b)(7)(ii)(B) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because the agreement provides that the 274 deduction limitations apply to K, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section, K and not J is subject to the limitations on deductions in paragraph (a) of this section.

The final example looks at the case where there is no agreement to reimburse expenses.

**EXAMPLE 4, PROPOSED REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT COVERED BY AGREEMENT**

The facts are the same as in Example 1 except that the agreement between J and K does not provide that K will reimburse J for travel expenses.

The arrangement between J and K is not a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3)(B) and paragraph (b)(7)(ii) of this section. Therefore, even though J accounts to K for the expenses, J is subject to the limitations on deductions in paragraph (a) of this section.

Note that without an agreement that the contractor will be reimbursed for covered expenses, even with an accounting the contractor will be stuck with the 50% disallowance.

*Recreational Expenses for Employees*

Expenses paid for food or beverages by a taxpayer for recreational, social or similar activities primarily for the benefit of employees is not subject to the 50% disallowance. However, special rules apply to the extent that some of the employees being provided the food are highly compensated employees.<sup>38</sup>

The regulation provides that it applies to “expenses paid or incurred for events such as holiday parties, annual picnics, or summer outings.”<sup>39</sup> However, it cannot be used to

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<sup>38</sup> Proposed Reg. §1.274-13(c)(2)(iii)(A)

<sup>39</sup> Proposed Reg. §1.274-13(c)(2)(iii)(A)

cover expenses that are excluded from the employees' wages because they actually represent meals paid for the convenience of the employer per IRC §119.<sup>40</sup>

The exclusion only applies to food or beverages made primarily for the benefit of employees other than the following highly compensated employees:

- Officers;
- Shareholders or other owners who own a 10% or greater interest in the business (counting interests owned by members of the family within the meaning of IRC §267(c)(4) as owned by that person); or
- Other highly compensated employees.<sup>41</sup>

This does not mean this “tainted group” cannot attend the function in question, but rather that the function must be primarily for the benefit of the rank and file. As the proposed regulation notes:

An expense for food or beverages is not to be considered outside of the exception of this paragraph (c)(2)(iii) merely because, due to the large number of employees involved, the provision of food or beverages is intended to benefit only a limited number of employees at one time, provided the provision of food or beverages does not discriminate in favor of officers, shareholders, other owners, or highly compensated employees.<sup>42</sup>

The IRS gives five examples of the recreational expense exception.

**EXAMPLE 1, PROPOSED REG. §1.274-13(C)(2)(III)(C), HOLIDAY PARTY AT A HOTEL**

Employer L invites all employees to a holiday party in a hotel ballroom that includes a buffet dinner and an open bar. Under section 274(e)(4), this paragraph (c)(2)(iii), and §1.274-11(c), the cost of the party, including food and beverage expenses, is not subject to the deduction limitations in paragraph (a) of this section because the holiday party is a recreational, social,

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<sup>40</sup> Proposed Reg. §1.274-13(c)(2)(iii)(A)

<sup>41</sup> Proposed Reg. §1.274-13(c)(2)(iii)(B)

<sup>42</sup> Proposed Reg. §1.274-13(c)(2)(iii)(B)

or similar activity primarily for the benefit of non-highly compensated employees. Thus, L may deduct 100 percent of the cost of the party.

The fact that the party did not discriminate in favor of the highly compensated employees was key in having this program qualify for a full deduction. Contrast the result with that in the second IRS example.

**EXAMPLE 2, PROPOSED REG. §1.274-13(C)(2)(III)(C), HOLDING PARTY FOR HIGHLY COMPENSATED EMPLOYEES ONLY WITH FOOD SEPARATELY INVOICED**

The facts are the same as in Example 1 except that Employer L invites only highly-compensated employees to the holiday party, and the invoice provided by the hotel lists the costs for food and beverages separately from the cost of the rental of the ballroom. The costs reflect the venue's usual selling price for food or beverages. The exception in this paragraph (c)(2)(iii) does not apply because L invited only highly-compensated employees to the holiday party. However, under §1.274-11(b)(1)(ii), the food and beverage expenses are not treated as entertainment. L may deduct 50 percent of the food and beverage costs that are separately stated on the invoice under paragraph (a)(2) of this section.

The IRS next moves on to snacks in the break room—and the IRS decides those foods will be subject to the 50% limitation.

**EXAMPLE 3, PROPOSED REG. §1.274-13(C)(2)(III)(C), SNACKS IN THE BREAK ROOM**

Employer M provides free coffee, soda, bottled water, chips, donuts, and other snacks in a break room available to all employees. The expenses associated with the food and beverages are subject to the deduction limitations in paragraph (a) of this section because the break room is not a recreational, social, or similar activity primarily for the benefit of the employees. Thus, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply and M may only deduct 50 percent of the expenses for food and beverages provided in the break room.

As well, if there is a job related reason to provide the food and drink for the convenience of the employer, the full 50% disallowance will apply.

**EXAMPLE 4, PROPOSED REG. §1.274-13(C)(2)(III)(C), MEALS FURNISHED TO KEEP EMPLOYEES ON SITE**

Employer N has a written policy that employees in a certain medical services-related position must be available for emergency calls due to the nature of the position that requires frequent emergency response. Because these emergencies can and do occur during meal periods, N furnishes food and beverages to employees in this position without charge in a cafeteria on N's premises. N excludes food and beverage expenses from the employees' income as meals provided for the convenience of the employer excludable under section 119. Because these food and beverages are furnished for the employer's convenience, and therefore are not primarily for the benefit of the employees, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even if some socializing related to the food and

beverages provided occurs. Thus, N may only deduct 50 percent of the expenses for food and beverages provided to employees in the cafeteria.

Similarly, the IRS decides that this exception can't be combined with a business meal even if a social celebration takes place with the employee during that meal.

**EXAMPLE 5, PROPOSED REG. §1.274-13(C)(2)(III)(C), BIRTHDAY DESERT AT A BUSINESS MEAL**

Employer O invites an employee and a client to dinner at a restaurant. Because it is the birthday of the employee, O orders a special dessert in celebration. Because the meal is a business meal, and therefore not primarily for the benefit of the employee, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even though an employee social activity in the form of a birthday celebration occurred during the meal. Thus, O may only deduct 50 percent of the meal expenses.

The last two examples likely were added to make clear the IRS is not inclined to be very tolerant about “creative” attempts to expand the recreational rule to cover other situations as taxpayers attempt to get a full deduction. The event must be purely recreational in nature, not “maybe” recreational (if there was no medical emergency during the meal) or partially recreational (the birthday cake at the end of the business meal).

*Food or Beverage Made Available to the Public*

If the food or beverage is made available to the general public, then the 50% disallowance of the deduction does not apply to the expenditure. This is true even if that food or beverage is also available to employees of the employer, so long as the same types of food or beverages are provided to and primarily consumed by the general public.<sup>43</sup>

The IRS provides four examples of what constitutes such items available to the general public.

**EXAMPLE 1, PROPOSED REG. §1.274-12(C)(2)(IV)(B), OPEN HOUSE OF REAL ESTATE AGENT**

Employer P is a real estate agent and provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by P's employees, potential buyers of the property, and other real estate agents. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations in paragraph (a) of this section if over 50 percent of the food and beverages are primarily consumed by potential buyers and other real estate agents. If the food and beverages are not primarily consumed by the general public, only the costs

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<sup>43</sup> Proposed Reg. §1.274-12(c)(2)(iv)(A)

attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

The last sentence of the example is a key one—the taxpayer must show the food and beverages were primarily consumed by the general public (in this case, other real estate agents and potential buyers), rather than by the employees of the employer.

The same caveat is repeated in the second example, this one involving an automotive service center waiting room.

**EXAMPLE 2, PROPOSED REG. §1.274-12(C)(2)(IV)(B), AUTO REPAIR WAITING AREA**

Employer Q is an automobile service center and provides refreshments in its waiting area. The refreshments are consumed by Q's employees and customers. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations provided for in paragraph (a) of this section if over 50 percent of the food and beverages are primarily consumed by customers. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

The next example deals with meals provided at a summer camp.

**EXAMPLE 3, PROPOSED REG. §1.274-12(C)(2)(IV)(B), SUMMER CAMP**

Employer R operates a summer camp open to the general public for children and provides breakfast and lunch, as part of the fee to attend camp, both to camp counselors, who are employees, and to camp attendees, who are customers. There are 20 camp counselors and 100 camp attendees. The same type of meal is available to each counselor and attendee, and attendees consume more than 50 percent of the food and beverages. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the food and beverages are not subject to the deduction limitations in paragraph (a) of this section, because over 50 percent of the food and beverages are primarily consumed by camp attendees. Thus, R may deduct 100 percent of the food and beverage expenses.

Note that the customers are treated as the general public in this case, though with the caveat that the camp is open to the general public. That suggests that there might be a point where restrictions on who could be a customer might lead to not treating customers as the general public.

As well, the example explicitly provides for a greater than 50% consumption test to determine if the food and beverages are primarily consumed by the general public. The next example emphasizes that the opposite is true—if more than 50% is consumed by employees, this exception won't work.

**EXAMPLE 4, PROPOSED REG. §1.274-12(C)(2)(IV)(B), COMPANY CAFETERIA**

Employer S provides food and beverages to its employees without charge at a company cafeteria on its premises. Occasionally, customers or other visitors also eat without charge in the cafeteria. The occasional consumption of food and beverages at the company cafeteria



by customers and visitors is less than 50 percent of the total amount of food and beverages consumed at the cafeteria. Therefore, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

### *Goods or Services Sold to Customers*

Food and beverages purchased for eventual sale to customers generally are also exempted from the 50% disallowance of a deduction. But the transaction must be one for adequate and full consideration in money or money's worth.<sup>44</sup>

The regulation provides that if a transaction fails that test, it will not qualify, stating:

However, money or money's worth does not include payment through services provided. Under this paragraph (c)(2)(v), a restaurant or catering business may deduct 100 percent of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are also consumed at the worksite by employees who work in the employer's restaurant or catering business. In addition, for purposes of this paragraph (c)(2)(v), the term customer includes anyone, including an employee of the taxpayer, who is sold food or beverages in a bona fide transaction for an adequate and full consideration in money or money's worth.<sup>45</sup>

The IRS provides the following single example for this provision.

#### **EXAMPLE, PROPOSED REG. §1.274-12(C)(2)(V)(B), RESTAURANT**

Employer T operates a restaurant. T provides food and beverages to its food service employees before, during, and after their shifts for no consideration. Under section 274(e)(8) and this paragraph (c)(2)(v), the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitation in paragraph (a) of this section because the restaurant sells food and beverages to customers in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, T may deduct 100 percent of the food and beverage expenses.

### ***Effective Date***

These regulations are proposed to apply to taxable years that begin on or after the date of their publication as final regulations. However, prior to the issuance of the final regulations, taxpayers can rely on these regulations for expenses incurred after

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<sup>44</sup> Proposed Reg. §1.274-12(c)(

<sup>45</sup> Proposed Reg. §1.274-12(c)(

## **22** Current Federal Tax Developments

December 31, 2017. As well, until the regulations are finalized, taxpayers can continue to rely on Notice 2018-76.<sup>46</sup>

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<sup>46</sup> REG-100814-19, February 21, 2020, p. 22