Commonly overlooked exceptions to the 50% disallowance for meal and entertainment expenses

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In brief

A taxpayer's deduction for business meal and entertainment expenses generally is limited to 50% of the costs incurred. Furthermore, certain entertainment costs, like those related to country club dues or luxury suites, may be completely disallowed as a deduction. While many taxpayers appropriately limit their deduction related to meal and entertainment expenses based on the 50% disallowance described above, some taxpayers overlook exceptions that may be applicable. Theses exceptions may allow taxpayers to deduct the entire cost of certain meal and entertainment expenses, thus permanently reducing their income tax liability.

In detail

Background

Taxpayers generally are entitled to deduct an ordinary and necessary meal and entertainment expense only if the expense is either 'directly related to' or 'associated with' the active conduct of a trade or business. Additionally, taxpayers must satisfy strict substantiation requirements supporting the business purpose of the expense. Taxpayers generally may deduct only 50% of the otherwise deductible cost of its meal and entertainment expense.

There are several statutory exceptions to the 50% disallowance for meal and entertainment expenses. To the extent that a specific meal or entertainment expense falls within one of these exceptions, the entire cost of that meal or entertainment expense may be deductible in full.

Statutory exceptions to the 50% disallowance

The statutory exceptions to the 50% disallowance generally include the following: (1) reimbursed expenses; (2) de minimis fringe benefits; (3) expenses for recreational, social, or other similar activities primarily for the benefit of employees; (4) expenses treated as taxable compensation to employees; (5) expenses includible in income of persons who are not employees; (6) entertainment sold to customers; and (7) expenses for items made available to the public.

Reimbursed expenses

Business meal and entertainment expenses incurred by a taxpayer may not be subject to the 50% disallowance if those costs are incurred by the taxpayer in performing services for another person under a reimbursement or other expense allowance arrangement with that other person. Therefore, if a client or customer reimburses the taxpayer for meal and entertainment expenses incurred by the taxpayer, the 50% disallowance would not apply to the extent the taxpayer accounts to their

client or customer as outlined by the substantiation requirements under Section 274(d). For this purpose, proper substantiation would include: (1) the amount of the expense; (2) the time and place the expense was incurred; (3) the business purpose for incurring the expense; and (4) the names and business relationships of the people in attendance. To the extent the substantiation is provided, the 50% disallowance would be imposed on the client or customer that is reimbursing the expense.

Observation: Expense reimbursement arrangements should contain provisions that make clear which party is to be subject to the 50% disallowance for meal and entertainment expenses. It is important to note that the client or customer needs to be aware that the taxpayer is passing on the meal and entertainment expense disallowance to them to prevent both parties from claiming a 100% deduction.

The IRS recently issued final regulations specifically addressing this exception to the 50% disallowance. A deeper discussion regarding the reimbursed expense exception can be found in this recent WNTS Insight: *IRS issues important guidance on reimbursement arrangements*, August 7, 2013.

De minimis fringe benefits

This exception to the 50% disallowance may be applicable to many taxpayers. Meal and beverage expenses incurred that would otherwise be subject to the 50% disallowance, but qualify as de minimis fringe benefits under Section 132, are 100% deductible by the taxpayer. While a detailed discussion of what constitutes a de minimis fringe benefit is beyond the scope of this article, below is a general overview.

Section 132(e)(1) defines a de minimis fringe benefit 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 the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable." Accordingly, there are three primary factors to consider when determining whether a benefit qualifies as a de minimis fringe: (1) frequency, (2) value, and (3) the administrative burden of accounting for the benefit. Therefore, in order to qualify as a de minimis fringe benefit, the benefit provided to an employee must be infrequent, have a low value, and be impractical to account for separately.

Observation: It is important to note that the de minimis fringe benefit exception to the 50% disallowance only applies to food and beverages. Examples of common expenses that may qualify as being 100% deductible under the de minimis fringe benefit exception include the occasional cocktail party, group lunch, coffee, soft drinks, or bagels.

Expenses for recreational, social, or other similar activities primarily for the benefit of employees

For purposes of this exception, recreational activities would include company holiday parties and annual company picnics or outings. Other activities that may qualify under this exception include activities that are for the purpose of improving the morale and communication of those invited. Thus, the costs associated with these activities would be 100% deductible.

Expenses for an activity or outing that is solely for the benefit of officers, majority shareholders (or other owners), or highly compensated employees will not be considered an activity primarily for the benefit of employees. As a result, those expenses will be subject to the 50% disallowance.

Observation: Many companies incur significant costs for company holiday parties, outings, and morale-building events. It is often helpful for taxpayers to establish separate general ledger accounts to record the costs associated with these types of activities in order to better track the costs that may qualify for this exception.

Expenses treated as taxable compensation to employees

To the extent that an amount paid for or on behalf of an employee for a meal or entertainment expense is included in that employee's compensation, the amount is 100% deductible by the employer as compensation. For example, if an employer treats as compensation the amount paid or incurred for a vacation trip awarded to an employee or for travel expenses (including meal and entertainment expenses) of a spouse, dependent, or other guest accompanying an employee on a business trip, then the expense is deductible in full by the employer as compensation. However, it should be noted that the deduction may be limited to the amount included in the recipient employee's W-2 wages if the recipient of the entertainment is a specified individual.

Expenses includible in income of persons who are not employees

This exception is similar to the previous exception (expenses included in income of employees) discussed above, but it pertains to non-employees. Meal and entertainment expenses included in the gross income of a non-employee are 100% deductible by the taxpayer as compensation for services. In order to qualify under this exception, the

taxpayer must report the value of the meal or entertainment expense on the applicable information return required to be filed by the taxpayer. For example, tickets to a sporting event provided to a non-employee service provider that is included in the Form 1099 issued to that non-employee would be 100% deductible by the taxpayer.

Observation: A taxpayer must be diligent in ensuring the meal and entertainment expenses to which they intend to apply this exception are included in the amount reported on the Form 1099 issued to the non-employee.

Entertainment sold to customers

To the extent costs are incurred for providing goods or services that are sold to customers in an arms-length transaction, those costs are not subject to the 50% disallowance. The purpose of this exception is to ensure that taxpayers selling entertainment to others are allowed to deduct the costs of producing that entertainment. Examples of these types of costs include the cost of producing night club entertainment for sale to customers or the cost of operating a cruise ship as a business.

Expenses for items made available to the public

Examples of items that would qualify under this exception include the cost of distributing samples to the general public, as well as expenditures for maintaining private parks, golf courses, or similar facilities, to the extent they are made available for public use.

The takeaway

The exceptions to the general rule limiting a taxpayer's meal and entertainment deductions to 50% of the otherwise allowable amount are often overlooked. Analyzing the nature of meal and entertainment expenses may allow taxpayers to deduct in full certain costs that would have otherwise been subject to the 50% disallowance, thus permanently reducing their income tax liability.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact the PwC professional listed below or your local PCS contact:

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