

IRS issues important guidance on reimbursement arrangements

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In brief

The IRS recently issued final regulations explaining the exception to the Section 274(n) 50-percent deduction limitation for certain expenditures paid or incurred under a reimbursement or other expense allowance arrangement. The final regulations are important for taxpayers that enter into reimbursement arrangements with their clients or customers for expenses that are subject to the 50-percent limitation of Section 274(n).

The regulations apply to any tax year beginning after August 1, 2013. However, in the preamble to the final regulations, the IRS states that taxpayers may rely on the rules for tax years beginning on or before August 1, 2013, for which the period of limitations under section 6511 has not expired.

With the final regulations being promulgated, taxpayers should use expense reimbursement arrangements containing provisions that make clear which party is to bear the expense and thus will be subject to the 50-percent limitation.

In detail

Background

Section 274(n)(1) generally limits a taxpayer's deduction for any business expense for food, beverages, entertainment, or use of entertainment facilities to 50 percent of the otherwise deductible amount paid or incurred. However, Section 274(e)(3) generally excepts from the 50-percent limitation expenses paid or incurred by a taxpayer in performing services for another person under a "reimbursement or other expense allowance arrangement" with the other person. This exception can apply either if the taxpayer is an

employee performing services for an employer or the taxpayer is an independent contractor performing services for a client or customer.

With regard to employees, if the employee is performing services for an employer, provides the employer with appropriate substantiation, and the employer does not treat the reimbursement for the business entertainment expense as compensation to the employee, the employee has no additional compensation and no deduction for such expense. The employer is subject to the 50-percent disallowance, unless another exception applies.

With regard to independent contractors, if the client or customer reimburses the expenses of an independent contractor in a reimbursement or other expense allowance arrangement, the 50-percent limitation does not apply to the independent contractor to the extent the independent contractor accounts to the client as required by Section 274(d). Otherwise, the independent contractor (rather than the client or customer) is subject to the 50-percent limitations, unless another exception applies.

Observation: In light of the many different types of

reimbursement arrangements in existence today between independent contractors and clients, there still can be uncertainty as to which party ultimately bears the expense and consequently is subject to the 50-percent limitation of Section 274(n). Prior IRS guidance and court decisions have not provided clear rules to address this issue.

Final regulations

Definition of reimbursement or other expense allowance arrangement

The final regulations define a reimbursement or other expense allowance arrangement involving employees as 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 in performing services as an employee.

With regard to independent contractors, a reimbursement or other expense allowance arrangement involving a person who is not an employee is an arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client for expenses the independent contractor pays or incurs in performing services if either:

- a written agreement between the parties expressly provides that the client or customer will reimburse the independent contractor for expenses that are subject to the 50-percent limitation, or
- a written agreement between the parties expressly identifies the party that is subject to the 50-percent limitation.

Note: In the preamble to the proposed regulations, the IRS sought

comments on the definition of reimbursement or other expense allowance arrangement and on alternative definitions or approaches that would ensure that the deduction limitations apply to one of the parties to an expense reimbursement arrangement. However, the IRS did not receive any comments on its request, and thus the definition remains unchanged from the proposed regulations.

Two-party reimbursement arrangements

Pursuant to the final regulations, the 50-percent limitation applies to reimbursement or other expense allowance arrangement with an employee, whether or not a payor is an employer. Thus, a payor includes an employer, an agent of the employer, or a third party. For example, either an independent contractor or a client or customer may be a payor under a reimbursement arrangement with an employee. Consequently, any party that reimburses an employee is a payor and bears the expense is subject to the 50-percent limitation on business entertainment expenses if the payment is not treated as compensation and wages to the employee.

In the case of a reimbursement or other expense allowance arrangement between an independent contractor and a client that includes an agreement expressly providing that the client will reimburse the independent contractor for expenses that are subject to the 50-percent limitation, the 50-percent limitation will not apply to an independent contractor that accounts to the client within the meaning of section 274(d).

However, the 50-percent limitation will apply to the independent contractor and not to the client if the

independent contractor fails to account to the client. Alternatively, under the new definition of reimbursement arrangement, the parties may enter into an express written agreement identifying the party that is subject to the 50-percent limitation.

Multiple-party reimbursement arrangements

With regard to multiple-party arrangements, the final regulations call for such arrangements to be analyzed as a series of two-party reimbursement arrangements. Examples in the final regulations illustrate that the 50-percent limitation applies to the party that receives an accounting and that ultimately bears the expense.

The takeaway

For contracts entered into in tax years beginning after August 1, 2013, independent contractors that desire to pass along the 50-percent limitation to customers or clients for reimbursed meal and entertainment expenses must ensure that such contracts contain provisions that meet the requirements of the final regulations.

Independent contractors should review existing contracts either to ensure they contain provisions that meet the requirements of the final regulations or to determine what language must be added to meet the requirements.

Let's talk

For a deeper discussion, please contact:

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