Bloomberg Tax

Tax Management Memorandum™

Final Regulations Differentiate Meals from Entertainment Expenses and Clarify Deductibility of Meal Expenses

By Ira B. Stechel[*]
Akerman LLP
New York, NY

On September 29, 2020, the IRS posted on its website final regulations under §274 (the ''Final Regulations'')[1] relating to the amendments made to that provision by the Tax Cuts and Jobs Act of 2017 (the ''TCJA'')[2] limiting the deductibility of meal and entertainment expenses. The Final Regulations largely adopted the provisions of the proposed regulations that had been published on February 26, 2020 (the ''Proposed Regulations''),[3] with some modifications that are described below.

The Final Regulations took effect for tax years beginning on the date of their publication in the Federal Register, which was October 9, 2020.

BACKGROUND TO THE ISSUANCE OF THE FINAL REGULATIONS

Section 162(a) provides that business expenses paid or incurred during a taxable year in carrying on any trade or business are deductible if such expenses are ''ordinary and necessary,'' a term generally assumed to encompass expenditures for meals and entertainment. Prior to the enactment of the TCJA, §274(a)(1), as a general rule, disallowed deductions with respect to expenses for entertainment, amusement, or recreation. Nevertheless, this disallowance was subject to a major exception for expenses that were ''directly related to'' or ''associated'' with the active conduct of the taxpayer's trade or business (referring, broadly, to a substantive business discussion occurring in conjunction with, or immediately preceding, or following the meal or entertainment). Regardless, even where these tests were met, the expenses incurred for entertainment and meals were generally subject to a 50% deduction limitation under §274(n). As a result, business meals and entertainment were usually treated as deductible at a 50% level before the TCJA.

The TCJA amended §274(a) to eliminate the exception for expenses directly related to or associated with the taxpayer's business. As a result, most entertainment expenses are now entirely nondeductible. However, the TCJA did not define the term ''entertainment'' or explain whether business meals are considered entertainment. Adding to the uncertainty was the fact that the language of the regulations under §274 defined ''entertainment'' as any activity ''generally considered to constitute entertainment, amusement, or recreation,'' which may include activities that satisfy the ''personal, living or family needs'' of an employee, such as providing food and beverages.[4] Moreover, the case law also traditionally treated business meal expenses as a form of entertainment expense and tested their deductibility under the tests of §274(a) (as

[*] Ira Stechel is a tax partner in the New York office of Akerman, LLP, and advises on tax planning, tax controversy, and employee benefits. Clients value Ira's comprehensive experience in navigating the wide range of tax issues encountered in both business and personal contexts. Ira is the author of Bloomberg Tax Management Portfolios 519 T.M., *Travel and Transportation Expenses – Deduction and Recordkeeping Requirements*, and 520 T.M., *Entertainment, Meals, Gifts and Lodging – Deduction and Recordkeeping Requirements*.

[1] T.D. 9925, Preamble, Meals and Entertainment Expenses Under Section 274, 85 Fed. Reg. 64,026 (Oct. 9, 2020). All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] Pub. L. No. 115-97.

[3] IRS Proposed Rules on Meals and Entertainment Expenses Under Section 274, REG-100814-19, 85 Fed. Reg. 11,020, 11,025 (Feb. 26, 2020).

[4] Reg. §1.274-2(b)(1)(i).

well as §274(k), discussed below), as well as the ''ordinary and necessary'' business expense criterion.[5]

In this regard, the Conference Committee report to the TCJA noted that the TCJA would allow taxpayers to still be able to deduct 50% of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel), while repealing the rule permitting deduction of entertainment expenses that are directly related to or associated with the active conduct of the taxpayer's trade or business.[6]

The issue was muddled, however, by a footnote in a report of the Joint Committee on Taxation, in which the Joint Committee interpreted §274, as amended, to prohibit the deduction of all entertainment expenses, including business meals.[7] Although this interpretation was consistent with the literal language of the law and the regulations, as well as prior case law, it did not align with the above-described Congressional intent, as reflected in the Conference Committee Report.

It also was inconsistent with post-TCJA §274(k), which provides:

> (k) Business meals.
>
> (1) In general – No deduction shall be allowed under this chapter for the expense of any food or beverages *unless* –
>
> (A) such 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 such food or beverages. [Emphasis added]

Thus, the combination of §274(k) and the statements of legislative intent bolstered the position of taxpayers who believed that meal expenses remained deductible post-TCJA. Skeptics, however, noted that §274, generally, is a disallowance provision and, in and of itself, authorizes no deduction that is otherwise unaddressed in the I.R.C.[8]

NOTICE 2018-76 AND THE REVIVAL OF THE ''QUIET BUSINESS MEAL''

On October 15, 2018, the Treasury and the IRS published Notice 2018-76,[9] providing transitional guidance pending the issuance of regulations under §274 on the deductibility of expenses for business meals and requesting comments for future guidance to further clarify and differentiate the treatment of business meal expenses and entertainment expenditures under §274. Under the notice, a taxpayer may deduct 50% of an otherwise allowable business meal expense if: (1) the expense is an ordinary and necessary expense under §162(a); (2) the expense is not lavish or extravagant under the circumstances; (3) the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages; (4) the food and beverages are provided to a current or potential business customer, client, consultant, or ''similar business contact;'' and (5) in the case of food and beverages provided at or during an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The notice also provided that the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

Notably, Notice 2018-76 did not require that business meal expenses must meet the former ''directly related to'' or ''associated with'' requirements of §274(a).

Thus, Notice 2018-76 may have had the unintended but ironic effect of reviving the deduction for the ''quiet business meal,'' which had been repealed 31 years previously by the Tax Reform Act of 1986.[10]

Up until its abrogation in 1986, §274(e)(1), as originally enacted in 1962 as part of §274, constituted an exception to the broad disallowance of entertainment expenses of §274(a), and provided:

> (e) Specific Exception to Application of Subsection (a) – Subsection (a) shall *not* apply to –
>
> (1) Business Meals. – Expenses for food and beverages furnished to any individual under circumstances which (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing ac-

[5] *See, e.g., Matlock v. Commissioner*, T.C. Memo 1992-324; *Ainsworth v. Commissioner*, T.C. Memo 1987-398; *Moylan v. Commissioner*, T.C. Memo 1968-15.

[6] H.R. Conf. Rep. 115-466, 115th Conf., 1st Sess. at 405-406 (2017).

[7] Joint Committee on Taxation, Overview of the Federal Tax System as in Effect for 2018 (JCX-3-18) at 13, n. 44 (Feb. 7, 2018).

[8] *See* Reg. §1.274-1.

[9] Notice 2018-76 constituted ''substantial authority'' for purposes of abating a §6662 penalty, pursuant to Reg. §1.6662-4(d)(3)(ii), which states that ''notices, announcements and other administrative announcements published by the Service in the Internal Revenue Bulletin'' are acceptable for determining whether there is substantial authority for the tax treatment of an item.

[10] Pub. L. No. 99-514, §142(a)(2)(A) (deleting former §274(e)(1)).

ISSN 0148-8295

> tivity and the relationship to such trade, business, or activity of the persons to whom the food and beverages are furnished) are of a type generally considered to be conducive to a business discussion. [Emphasis added] The purpose of the inclusion of §274(e)(1) in the statute was to exempt the costs of such ''quiet business meals'' from the requirements for deductibility of entertainment expenses, given the traditional view of Congress that meal expenses were otherwise a species of entertainment costs.[11]

Likewise, the ''Blue Book,'' published by the Joint Committee on Taxation following enactment of the Tax Reform Act of 1986, reflected the view that business meals constitute entertainment costs, stating:

> Under prior law, expenses for food and beverages were deductible, *without regard* to the ''directly related'' or ''associated with'' requirement generally applicable to entertainment expenses, if the meal or drinks took place in an atmosphere conducive to business discussion. There was no requirement under prior law that business actually be discussed before, during, or after the meal. [Emphasis added][12]

By the same token, Notice 2018-76, like former §274(e)(1), eliminates the ''directly related to'' and ''associated with'' tests, thereby eliminating any requirement that business matters actually be discussed at the meal, so long as the circumstances are conducive to a business discussion (meaning that the food and beverages are provided to a current or potential business customer, client, consultant or ''similar business contact,'' and the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or business. Of course, while the bedrock ''ordinary and necessary'' business expense threshold remains in place, a taxpayer's attempt to establish goodwill towards a business by feeding a business contact should satisfy that criterion.

PROPOSED REGULATIONS EXPAND ON NOTICE 2018-70

The Proposed Regulations, responding to the enactment of the TCJA, contain two new regulatory sections: Prop. Reg. §1.274-11, addressing disallowed deductions for entertainment, amusement or recreation expenditures paid or incurred after December 31, 2017, and Prop. Reg. §1.274-12, addressing the limitation on certain food or beverage expenses paid or incurred after December 31, 2017.

Significantly, the Proposed Regulations did not contain any revisions of the regulations at Reg. §1.274-2, which extended back to 1963 and had first interpreted the limitation on entertainment deductions and the applicable exceptions as originally enacted in 1962. In fact, the ''Proposed Applicability Date'' of the Proposed Regulations provided that taxpayers could continue to rely on those existing rules to the extent applicable and not superseded by the TCJA.[13]

The Proposed Regulations also followed Notice 2018-76 in treating food or beverages provided at an entertainment activity as a nondeductible entertainment expense unless the food or beverages were purchased separately from the entertainment, or the cost of the food or beverages was stated separately from the cost or the entertainment on bills, invoices, or receipts. The Proposed Regulations clarified that the receipt amount 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.''[14] If the food or beverages was not separately purchased or itemized, no allocation of the cost was permitted. Rather, the full cost would then be treated as a nondeductible entertainment expense.[15]

The Proposed Regulations also incorporated other statutory requirements for deductibility of meal costs (i.e., expenses for food and beverages) under §162 and §274(k) by requiring that (1) the expenses not to be lavish or extravagant under the circumstances; (2) the taxpayer, or the taxpayer's employee, to be present at the furnishing of the food or beverages; and (3) the food or beverages to be provided to a business associate. For these purposes, the Proposed Regulations, consistent with Reg. §1.274-2(b)(2)(iii), define a ''business associate'' as 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.''[16]

The Proposed Regulations, which also included Prop. Reg. §1.274-12(a)(4), include specific rules concerning meal expenditures incurred while travelling for business. While these rules were not amended

[11] *See, e.g.,* the Senate Finance Committee Report accompanying the Revenue Act of 1962, which commented that ''entertainment includes any business expense incurred in the furnishing of food and beverages.'' S. Rep. No. 1881, 87th Conf., 2d Sess. 27 (1962).

[12] Joint Committee in Taxation, General Explanation of the Tax Reform Act of 1986 (JCS-10-87) at 58.

[13] *See* IRS Proposed Rules on Meals and Entertainment Expenses Under Section 274, 85 Fed. Reg. 11,020, 11,025 (Feb. 26, 2020).

[14] Prop. Reg. §1.274-11(b)(1)(ii).

[15] Prop. Reg. §1.274-11(b)(1)(ii).

[16] Prop. Reg. §1.274-12(a)(1), §1.274-12(b)(3).

ISSN 0148-8295

by the TCJA, the proposed regulations consolidated the rules in one place.

Finally, the Proposed Regulations clarified at Prop. Reg. §1.274-12(c)(2), stated that the 50% limitation did not apply to expenditures for business meals, travel meals, or other food or beverages that fall within the §274(e) exceptions provided in §274(n). These were: expenses treated as compensation, under §274(e)(2) and §274(e)(9), reimbursed expenses under §274(e)(3), recreational expenses for employees under §274(e)(4), items available to the public under §274(e)(7), and goods or services sold to customers under §274(e)(8).

FINAL REGULATIONS CONFIRM THE SEVERABILITY OF MEAL EXPENSES FROM ENTERTAINMENT EXPENDITURES

As noted above, the Final Regulations largely adopted the Proposed Regulations with minor modifications, and, in response to comments, added additional examples.

In the Summary of Comment and Explanation of Provisions portion of T.D. 9925 (the ''Preamble''), providing an explanation of the regulations as finally adopted, the Treasury and the IRS indicate that they firmly support the continued deductibility of meal expenses, notwithstanding the statutory language assimilating meal expenses to entertainment expenditures:

> The Treasury Department and the IRS believe that Congress, in amending section 274 in the TCJA, intended that expenses for business meals be considered food or beverage expenses associated with operating a taxpayer's trade or business, and therefore generally remain 50 percent deductible. The Treasury Department and the IRS acknowledge that, prior to the TCJA, some meals were considered to be entertainment. However, prior to the TCJA, neither section 274 nor the regulations under section 274 attempted to define meal expenses or to distinguish meal expenses from entertainment expenses. . . . the Treasury Department and the IRS believe that the proposed regulations are consistent with the plain reading of section 274 after the TCJA, which clearly contemplates different treatment for meal expenses and entertainment expenses. In addition, the existing regulatory definition of entertainment relies upon an objective test to determine whether an activity is of a type generally considered to constitute entertainment. Providing that business meals are not of a type generally considered to constitute entertainment results in an administrable rule that does not depend on subjective factors such as whether the taxpayer enjoys the business meal. Thus, the final regulations adopt the proposed rule providing that business meals generally remain 50 percent deductible. The Treasury Department and the IRS believe that the final regulations provide a rule that is legally supportable and that draws a clear line between meals and entertainment that taxpayers can understand and the IRS can administer.[17]

Set forth below are the key aspects of the Final Regulations with respect to the deduction of the cost of food and beverages served in the context of business meals and their differentiation from entertainment expenditures.

ENTERTAINMENT EXPENDITURES

The Final Regulations restate the statutory rules under §274(a), and the existing definition of entertainment in Reg. §1.274-2(b)(1), with minor modifications, is incorporated into the Final Regulations, at Reg. §1.274-11(b)(1). The Final Regulations also provide that for purposes of §274(a), the term ''entertainment'' does not include food or beverages unless the food or beverages are provided at or during an entertainment activity and the costs of the food or beverages are not separately stated from the entertainment costs.[18]

Section 274(e) Exceptions to Section 274(a)

The Final Regulations, at Reg. §1.274-11(c), confirm the continued application of the nine exceptions in §274(e) to entertainment expenditures otherwise disallowed by §274(a). However, the TCJA did not change the application of the §274(e) exceptions to entertainment expenditures, so, other than confirming that the §274(e) exceptions continue to apply to entertainment expenditures, the Final Regulations do not provide rules addressing how the §274(e) exceptions apply to entertainment expenditures. The Preamble explains that taxpayers may continue to rely upon the existing rules and examples in Reg. §1.274-2 to the extent they are not superseded by the TCJA or other legislation and are not inconsistent with the final regulations.[19]

Separately Stated Food or Beverages not Entertainment

The Final Regulations substantially incorporate the guidance in Notice 2018-76 to distinguish between

---

[17] T.D. 9925, Preamble, 85 Fed. Reg. 64,026, 64,029 (Oct. 9, 2020).

[18] Reg. §1.274-11(b)(1)(ii).

[19] T.D. 9925, Preamble, 85 Fed. Reg. 64,026, 64,029 (Oct. 9, 2020).

ISSN 0148-8295

entertainment expenditures and food or beverage expenses in the context of business meals provided at or during an entertainment activity. In addition, the Final Regulations generally apply the guidance in Notice 2018-76 to all food or beverages, including travel meals and employer-provided meals, provided at or during an entertainment activity.[20]

As discussed above, Notice 2018-76 explained that in the case of food and beverages provided at or during an entertainment activity, the taxpayer may deduct 50% of an otherwise allowable business expense if the food and beverages are purchased separately from the entertainment, or if the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The notice provides that the entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages. The Final Regulations clarify this requirement by providing that 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.[21]

Conversely, the Final Regulations provide that in cases where the food or beverages provided at or during an entertainment activity are not purchased separately from the entertainment, and where the cost of the food or beverages is not 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.[22]

FOOD OR BEVERAGE EXPENSES

Business Meal Expenses

The Final Regulations substantially incorporate the guidance in Notice 2018-76 addressing business meals provided at or during an entertainment activity. The Final Regulations also incorporate other statutory requirements taxpayers must meet to deduct 50% of an otherwise allowable food or beverage expense. Specifically, the Final Regulations provide at Reg. §1.274-12(a)(1) that the expense must not be lavish or extravagant under the circumstances, and the taxpayer, or an employee of the taxpayer, must be present at the furnishing of the food or beverages.

Definitionally, the Final Regulations provide that the deduction limitation rules generally apply to all food and beverages, whether characterized as meals, snacks, or other types of food or beverage items. In addition, unless one of six exceptions under §274(e) applies, the deduction limitations apply regardless of whether the food or beverages are treated as de minimis fringe benefits under §132(e).[23]

Also, the Final Regulations define food or beverage expenses to mean the cost of food or beverages, including any delivery fees, tips, and sales tax. Indirect expenses, including the cost of transportation to a meal, are not included in the definition. In the case of employer-provided meals at an eating facility, 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.[24]

In addition, the Final Regulations address the general requirement in Notice 2018-76 that the food and beverages be provided to a business contact, which was described in Notice 2018-76 as a ''current or potential business customer, client, consultant, or similar business contact.'' The Final Regulations substitute the term ''business associate'' for ''business contact,'' as used in Notice 2018-76, and the term ''business associate'' is defined as ''a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct or the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.''[25] Accordingly, since employees are considered a type of business associate, a deduction would be allowable for expenses for meals provided by a taxpayer to both employees and nonemployee business associates at the same event.

Travel Meal Expenses

Although the TCJA did not specifically amend the rules for travel expenses, the Final Regulations are intended, consistent with the Proposed Regulations, to provide comprehensive rules for the deductibility of food and beverage expenses, and they therefore apply the general rules for meal expenses from Notice 2018-76 and the Proposed Regulations to travel meals.[26] In addition, the Final Regulations incorporate the substantiation requirements in §274(d), unchanged by the TCJA, to travel meals.[27] Finally, the Final Regulations apply the limitations in §274(m)(3) to expenses for food or beverages paid or incurred while on travel for spouses, dependents, or other indi-

[20] Reg. §1.274-11(b)(1)(ii), §1.274-12(a).
[21] Reg. §1.274-11(b)(1)(ii).
[22] Reg. §1.274-11(b)(1)(ii).
[23] Reg. §1.274-12(b)(1).
[24] Reg. §1.274-12(b)(2).
[25] Reg. §1.274-12(b)(3).
[26] Reg. §1.274-12(b)(4)(i).
[27] Reg. §1.274-12(b)(4)(ii).

ISSN 0148-8295

viduals accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel.[28]

Other Food or Beverage Expenses

The Final Regulations apply the business meal guidance in Notice 2018-76, as revised in the Proposed Regulations, to food or beverage expenses generally. Under §274(n)(1), the deduction for food or beverage expenses is broadly limited to 50% of the amount that would otherwise be allowable. Prior to the TCJA, under §274(n)(2)(B), expenses for food or beverages that were excludable from employee income as de minimis fringe benefits under §132(e) were not subject to the 50% deduction limitation under §274(n)(1) and could be fully deducted. The TCJA repealed §274(n)(2)(B) so that expenses for food or beverages excludable from employee income under §132(e) are subject to the §274(n)(1) deduction limitation, unless another exception under §274(n)(2) applies.

As noted previously, §274(k)(1) provides that in order for food or beverage expenses to be deductible, the food or beverages must not be lavish or extravagant under the circumstances and the taxpayer or an employee of the taxpayer must be present at the furnishing of the food or beverages. However, §274(e), as also noted, provides six exceptions to the limitations on the deduction of food or beverages in §274(k)(1) and §274(n)(1). The Final Regulations explain how those exceptions apply and supply illustrative examples. These provide guidance regarding the deductibility of expenses for: (1) food or beverages provided to food service workers who consume the food or beverages while working in a restaurant or catering business; (2) snacks available to employees in a pantry, break room, or copy room; (3) refreshments provided by a real estate agent at an open house: (4) food or beverages provided by a seasonal camp to camp counselors; (5) food or beverages provided to employees at a company cafeteria; and (6) food or beverages provided at company holiday parties and picnics.[29]

Section 274(e) Exceptions to Section 274(k) and 274(n)

Section 274(k)(2)(A) and §274(n)(2)(A) provide that the limitations on deductions in §274(k)(1) and §274(n)(1), respectively, do not apply to any expense described in §274(e)(2), §274(e)(3), §274(e)(4), §274(e)(7), §274(e)(8), and §274(e)(9). Reg. 1.274-12(c) of the Final Regulations, therefore, provides that the deduction limitations are not applicable to deductions for food or beverages that fall within one of these exceptions.

Expenses Treated as Compensation under Section 274(e)(2) or Section 274(e)(9)

Pursuant to §274(e)(2), the Final Regulations provide at Reg. §1.274-12(c)(2)(i)(A) that the limitations in §274(k)(1) and §274(n)(1) do not apply to expenditures for food or beverages provided to an employee of the taxpayer to the extent the taxpayer treats the expenses as compensation to the employee on the taxpayer's income tax return as originally filed and as wages to the employee.

Similarly, pursuant to §274(e)(9), the Final Regulations provide at Reg. §1.274-12(c)(2)(i)(B) that the limitations in §274(k)(1) and §274(n)(1) do not apply to expenses for food or beverages provided to a person who is not an employee of the taxpayer to the extent the expenses are includible in the gross income of the recipient of the food or beverages as compensation for services rendered or as a prize or award under §74.

The exceptions in §274(e)(2) relating to employees and in §274(e)(9) relating to non-employees had been interpreted by case law as allowing a taxpayer to deduct the full amount of an expense if the expense had properly been included in the compensation and wages of the employee, or gross income of the non-employee, even if the amount of the expense exceeded the amount included in compensation or income.[30] In 2004, however, Congress reversed this result by enacting §274(e)(2)(B) with regard to ''specified individuals.''[31] Thus, with regard to employees or non-employees who are specified individuals, §274(e)(2)(B)(i) provides an exception to the §274(n) limitation only ''to the extent that the expenses do not exceed the amount of the expenses which'' are treated as compensation and wages to the employee or as income to a non-employee.

Accordingly, the Final Regulations provide with respect to specified individuals, that the exceptions of §274(e)(2) and §274(e)(9) generally apply only to the extent that the food or beverage expenses do not exceed the amount of the food or beverage expenses treated as compensation under §274(e)(2), or as income (under §274(e)(9)) to the specified individual.

In the case of an employee who is not a specified individual who receives food or beverages, the Final

[28] Reg. §1.274-12(b)(4)(iii).

[29] *See* Reg. §1.274-12(c)(2)(i)(E)–§1.274-12(c)(2)(ii)(E), Reg. §1.274-1(c)(2)(iii)(B)-§1.274-12(c)(2)(iv)(B), Reg. §1.274-12(c)(2)(v)(B).

[30] *See Sutherland Lumber-Southwest Inc. v. Commissioner*, 114 T.C. 197 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.*, AOD 2002-02.

[31] A ''specified individual'' is, generally, an employee who is an officer, director or 10% owner. *See* §274(e)(2)(B)(ii).

ISSN 0148-8295

Regulations provide that the expense for the food or beverages is not subject to the deduction limitation to the extent that the taxpayer treats the expense as compensation to the employee, and the proper amount of compensation must be determined under the valuation rules of Reg. §1.61-21.[32]

In what was likely the most controversial provision of the Proposed Regulations, the Treasury and IRS took the position that expenses for food or beverages for which the taxpayer calculated a value that was less than the amount required to be included in gross income under Reg. §1.61-21, or for which the amount required to be included in gross income is zero, would not be considered as having been treated as compensation and as wages to the employee, or as includible in gross income by a recipient of the food or beverages who is not an employee of the taxpayer, for purposes of §274(e)(2) and §274(e)(9).[33]

Responding to several critical comments regarding this ''all or nothing'' rule, the Final Regulations termed it ''unduly harsh''[34] and modified the provision to instead allow the taxpayer to deduct meal expenses to the extent that the expenses do not exceed the amount of the expenses that are treated as compensation and wages or gross income.[35] Also, reimbursed amounts from the recipient will be taken into account in determining the amount properly includible in the recipient's income and will not affect the taxpayer's ability to avail itself of the exception in §274(e)(2)(A) or §274(e)(9).[36]

The Preamble further notes that, notwithstanding its modification of the ''all or nothing'' provision of the Proposed Regulations, the Treasury Department and the IRS continue to believe that if the amount to be included in compensation and wages or gross income is zero, whether zero is a proper or improper amount, the exceptions in §274(e)(2) and §274(e)(9) do not apply because no amount has been included in compensation and wages or gross income. To illustrate, if the amount to be included is zero because the value of the food or beverages is excluded as a fringe benefit under §132, the exceptions in §274(e)(2) and §274(e)(9) do not apply. Similarly, the exceptions in §274(e)(2) and §274(e)(9) do not apply if the amount to be included is zero solely because the recipient has fully reimbursed the taxpayer for the food or beverages.[37]

Food or Beverage Expenses Provided under Reimbursement Arrangements

Pursuant to §274(e)(3), the Final Regulations provide that in the case of expenses for food or beverages paid or incurred by one person in connection with the performance of services for another person (whether or not the other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on deductions in §274(k)(1) and §274(n)(1) apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. Section 274(e)(3)(B) provides that if the services are performed for a person other than an employer, such as an independent contractor, the exception in §274(e)(3) applies only if the taxpayer, in this case, the independent contractor, accounts, to the extent provided by §274(d), to such person. The Final Regulations therefore provide that the deduction limitations in §274(k)(1) and §274(n)(1) apply to an independent contractor unless, under a reimbursement or other expense allowance arrangement, the contractor accounts to its client or customer with substantiation that satisfies the requirements of §274(d).[38]

Recreational Expenses for Employees

The Final Regulations provide, pursuant to §274(e)(4), that any food or beverage expense paid or incurred by a taxpayer for a recreational, social, or similar activity, primarily for the benefit of the taxpayer's employees, is not subject to the deduction limitations in §274(k)(1) and §274(n)(1). However, activities that discriminate in favor of highly compensated employees, officers, shareholders or others who own a 10% or greater interest in the business are not considered paid or incurred primarily for the benefit of employees.[39]

An example in the Proposed Regulations sought to demonstrate that the exception in §274(e)(4) did not apply to free food or beverages available to all employees in a pantry, break room, or copy room, on the grounds that the mere provision or availability of food or beverages is not a recreational, social, or similar activity, despite the fact that employees may inciden-

---

[32] Reg. §1.61-21(b)(1) provides rules for the valuation of fringe benefits and requires that an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the amount paid for the benefit and the amount, if any, specifically excluded under the I.R.C.

[33] Prop. Reg. §1.274-12(c)(2)(i)(C).

[34] T.D. 9925, Preamble, 85 Fed. Reg. 64,026, 64,031 (Oct. 9, 2020).

[35] Reg. §1.274-12(c)(2)(i)(D). This is referred to as the ''dollar for dollar methodology.'' *See* T.D. 9925, Preamble, 85 Fed. Reg. 64,026, 64,031 (Oct. 9, 2020).

[36] Similar treatment is afforded to specified individuals under Reg. §1.274-12(c)(2)(i)(C)(2).

[37] T.D. 9925, Preamble, 85 Fed. Reg. 64,026, 64,031 (Oct. 9, 2020).

[38] Reg. §1.274-12(c)(2)(ii)(D).

[39] Reg. §1.274-12(c)(2)(iii)(A). See §274(e)(4), referencing the definition of ''highly compensated employee'' in §414(q).

ISSN 0148-8295

tally socialize while they are in the break room.[40] The Final Regulations adopted the Proposed Regulations with respect to the application of §274(e)(4) in this context.[41]

In addition, the Final Regulations provide that the exception in §274(e)(4) does not apply to food or beverage expenses that are excludable from employees' income under §119 as meals provided for the convenience of the employer, since they are, by definition, furnished for the employer's convenience and therefore cannot also be primarily for the benefit of the employees.[42]

Items Available to the Public

The Final Regulations provide, in accord with §274(e)(7), that food or beverage expenses of a taxpayer are not subject to the deduction limitations in §274(k)(1) and §274(n)(1) to the extent the food or beverages are made available to the general public. In addition, the Final Regulations provide that this exception applies to expenses for food or beverages provided to employees if similar food or beverages are provided by the employer to, and are primarily consumed by, the general public. For this purpose, ''primarily consumed'' means greater than 50% of actual or reasonably estimated consumption, and ''general public'' includes, but is not limited to, customers, clients, and visitors. The Final Regulations also provide that the general public does not include employees, partners, two-percent shareholders of S corporations, or independent contractors of the taxpayer. Nor does an exclusive list of guests constitute the general public.[43]

Goods or Services Sold to Customers

Pursuant to §274(e)(8), the Final Regulations provide that any expense for food or beverages that are sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth is not subject to the deduction limitation of §274(k)(1) and §274(n)(1). The term ''customer'' includes anyone who is sold food or beverages in a bona fide transaction for an adequate and full consideration in money or money's worth, and the term can include employees who otherwise meet the description.[44]

The Preamble also explained that the amendments made by the TCJA to limit the deduction for expenses of the employer associated with providing food or beverages to employees through an employer-operated eating facility that meets the requirements of §132(e)(2) do not affect other exceptions to the 50% limitation on deductions for food or beverage expenses.[45] Thus, the Final Regulations adopt the position that a restaurant or catering business may continue to deduct 100% 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.[46]

CONCLUSION

The Final Regulations are largely pro-taxpayer and reflect the position that Congress did not intend to amend the provisions relating to the deductibility of business meals in the course of eliminating the deduction for entertainment expenses. Thus, in accordance with the legislative history, and despite the statutory language seemingly to the contrary, taxpayers may continue to deduct 50% of the food and beverage expenses related to operating their trade or business, including meals consumed by employees on work travel. Pursuant to §274(k), the only extraneous limitations imposed upon such deductions is that the expense may not be lavish or extravagant under the circumstances and that the taxpayer or an employee of the taxpayer must be present at the furnishing of the food or beverages. However, unlike the statutory criteria in effect prior to the TCJA, it does not appear that an actual business discussion needs to take place before, during or after the meal.

---

[40] Prop. Reg. §1.274-12(c)(2)(iii)(C), *Ex.* 3.

[41] Reg. §1.274-12(c)(2)(iii)(B).

[42] Reg. §1.274-12(c)(2)(iii)(A).

[43] Reg. §1.274-12(c)(2)(4)(A); §1.274-12(b)(8), §1.274-12(9). *See also Churchill Downs, Inc. v. Commissioner*, 307 F.3d 423 (6th Cir. 2002).

[44] Reg. §1.274-12(c)(2)(v)(A).

[45] T.D. 9925, Preamble, 85 Fed. Reg. 64,026, 64,027 (Oct. 9, 2020).

[46] Reg. §1.274-12(c)(2)(v)(B).

ISSN 0148-8295