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TAX PLANNING LETTER

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Determining Which Meal and Entertainment Expenses Remain Deductible Under TCJA (Part 1)

The Tax Cuts and Jobs Act (TCJA) ushered in significant changes to familiar business expenses . . . expenditures for meals and entertainment. This Tax Planning Letter, as well as next month's Part 2, seeks to demonstrate that, while the deductibility of many entertainment expenses have been terminated after 2017, some do remain.

Likewise, while some meal expenses are also spared non-deductbility, questions linger as to the deductibility of the most familiar type of meal expense . . . that being the so-called "business meals" during which a meaningful and authentic discussion of business is present during the meal.

- Part 1 provides an overview of the changes brought about by TCJA and analyzes whether a "business meal" can continue to be deducted under TCJA.
- Part 2 covers the rules of deductibility for meals provided to employees on the premises of the company, as well as the sort of expenses that are excepted from statutory restrictions on meals and entertainment.

OVERVIEW OF THE MEAL AND ENTERTAINMENT RULES (Pre- and Post-TCJA)

PRE-TCJA

No deduction was allowed for "ordinary and necessary" expenses for an activity of a type generally considered to be entertainment, amusement, or recreation, or for a facility used in connection with such an activity, unless the taxpayer was able to support the premise that the expense was:

- directly related to, or
- in the case of an item directly preceding or following a substantial and bona fide business discussion, associated with

the active conduct of the taxpayer's trade or business or income-producing activity.

Practically speaking, meal expenses were treated as "within" entertainment expenses and, under the Tax Reform Act of 1986 (TRA86), were subject to the "directly related to" or "associated with" business requirements.

Basically, the deduction for meal and entertainment expenses was limited to 50% of the otherwise deductible amount of the expense.

UNDER TCJA

Beginning in 2018, the rule that allowed a deduction for entertainment, amusement, or recreation expenses that were directly related to (or associated with) the active conduct of the taxpayer's trade or business is summarily withdrawn. Instead, the general rule is that an otherwise allowable deduction cannot be claimed for an activity which is of a type generally considered to constitute entertainment, amusement or recreation, or with respect to a facility used in connected with such an activity. As such, the restriction on deductibility applies to the cost of tickets to sporting events, stadium license fees, private boxes at sporting events, theater tickets, golf club dues, etc.

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The TJCA also provides, generally, that only 50% of otherwise allowable expenses for meals are allowable as a deduction.

Example: *A lawyer takes a client to a sporting event.*

- *Pre-TCJA treatment is that 50% of the cost was deductible as entertainment "associated with" the active conduct of a trade or business (assuming that corroborating records of the event were kept)*
- *TCJA treatment is that there is no deduction for the cost of such entertainment.*

It was TRA86 that added the further provision *[§274(k)]* that a meal expense is not deductible unless:

- the expense is not lavish and extravagant under the circumstances, and
- the taxpayer (or an employee of the taxpayer) be present at the provision of such food or beverages.

These additional requirements for meals were not altered by TCJA.

IS A "BUSINESS MEAL" DEDUCTIBLE UNDER TCJA?

TCJA itself does not explain the tax treatment of an expense commonly described as a "business meal." For example, a substantial and bona fide business discussion between a business person and a client, takes place during a meal at a restaurant . . . or which begins at the office and continues over a meal at a restaurant.

PRE-TCJA
Such a meal was treated as "directly related" to the active conduct of a trade or business if, generally speaking:

- the main purpose of the event was the active conduct of business,
- the taxpayer had more than a general expectation of deriving income, or another specific benefit, from the meal, and
- the taxpayer did, in fact, actively engage in a business meeting, negotiation, discussion, or transaction during the meal

Subject to the foregoing, the cost of such a meal was 50% deductible if:

- the §274(k) requirements were met, and
- the expense was contemporaneously substantiated as to time, place, amount and business purpose

UNDER TCJA
The §274(k) provisioned "business meals" (the additional requirements of which apply to meals only) are retained . . . inclusive of the requirement that an agent of the taxpayer be present at the meal.

This has the implication that a "business meal" might continue to be 50% deductible. However, TCJA abolishes the "directly related to" or "associated with" standards that used to apply to business meals and entertainment. As such, it is not certain what criteria a "business meal" would have to meet in order to be deductible, over and above the normal §162(a) "ordinary and necessary business expense" rules.

Observation: *This particular matter, which IRS will hopefully clarify soon, has immediate and ongoing tax implications:*

- *not only for self-employed individuals who have business meals,*
- *but also for employers who require employees to initiate and participate in "business meals,"*
- *and for the employees themselves.*

Time honored regulations state that, an employee expense that is reimbursed by the employer is treated as made under a so-called "accountable plan" only if it meets a "business connection" requirement, among other criteria. This requirement states that the expense must be incurred for an otherwise deductible business expenditure that is paid or incurred by an employee in "connection" with performing services as an employee of the employer. As we know, amounts reimbursed under such an "accountable plan" are tax-free to the employee. Inversely, the employer deducts the reimbursement, subject to whatever deductibility restrictions may apply to such underlying expense (such as the 50% deduction limitation on business meals).

The expenditure is automatically treated as made under a "non-accountable plan" in the event the "business connection" requirement is not

met. In that eventuality, the amount of the expenditure must be treated as wages to the employee, subject to payroll tax and income tax withholding when paid. Under this treatment, the employer deducts the reimbursement amount as compensation.

Under §274 as revised by TCJA, the employer's deduction for an amount paid that's treated as compensation to the employee (such as an amount paid under the aforementioned "non-accountable plan" scenario), is not subject to:

- the general §274(a) disallowance rule,
- the §274(k) special requirements for business meals, or
- the §274(n) 50% deduction limit on meals.

Example: *An employee takes a client to a "business meal" to discuss business and pays the bill with a company provided credit card. He timely complies with the substantiation requirement (with regards to time, place, amount, business purposes, and of course a copy of the receipt). The treatment of this activity, if it took place in 2017, was that the entire reimbursement was treated as made under an "accountable plan" and was tax-free to the employee. Inversely, the employer deducted 50% of the expenditure.*

Were the foregoing event to have taken place in 2018, the results would remain the same with the IRS relying on a committee report statement to continue to treat the expense as 50% deductible under §162 (ordinary and necessary business expense) and §274 (disallowance of certain entertainment expenses). If the expense is treated as non-deductible, however, then the 2018 expense would be treated as paid under a "non-accountable plan". What this means is that it would be included in the employee's wages and would be subject to payroll tax and income tax withholding. The employer, on the other hand, would effectively deduct the meal expense in full.

Observation: *The same scenario, except replacing the employee with an independent contractor who pays for a "business meal" on behalf of a client in 2018 would tangentially parallel that of an employee's "business meal" on behalf of an employer.*

If the "business meal" is still a deductible expense, an independent contractor who accounts in full (e.g. an "accountable plan") for the expense to his client would not be subject to any of the §274(a) limitations. Inversely, the client would be subject to the §274 limitations (e.g. the 50% disallowance for meal expenses). If the "business meal" is not deducible under §274(a)(1), then the expense would have to be reported on Form 1099 and the amount of the expense would be deductible in full by the client.)

Questions?

For more details on information presented in this Tax Planning Letter or other issues, please feel free to call Roger Rossmeisl, CPA direct at (714) 325-0442 or via e-mail at *roger@khopatel.com.*