Tax readiness: Meals, entertainment, and related fringe benefits after tax reform

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In brief

The comprehensive federal tax reform legislation enacted in late 2017 (the Act) made a number of changes to the tax rules affecting the treatment of meals, entertainment, and related fringe benefits. On July 30 PwC hosted a webcast featuring specialists who discussed these issues. This Insight highlights those discussions.

In detail

Rules prior to tax reform

Entertainment before tax reform: Section 274(a)

The deduction for expenses for an entertainment (broadly defined as amusement or recreation) activity was subject to a higher standard than other trade or business expenses. The expenses had to be directly related to the active conduct of the taxpayer's trade or business or directly preceding or following a substantial and bona fide business meeting that was associated with the active conduct of trade or business. In addition, there were more extensive substantiation requirements under Section 274(d) than under Section 162.

No deduction was allowed for entertainment facilities, such as a golf course or hunting lodge. Dues or fees for social, athletic, or sporting clubs or organizations were treated as for facilities. There was an exception for a club used primarily for furtherance of and directly related to the active conduct of a trade or business.

Section 274(e) provided nine exceptions to the Section 274(a) rules.

The Section 274(a) deduction was subject to the 50% limitation of Section 274(n) unless one of six Section 274(e) exceptions to the Section 274(n) rules applied.

Exceptions: Section 274(e)

Section 274(a) did not apply to:

- Food and beverages furnished primarily to employees on business premises and related eating facilities (not applicable to the 50% limitation)
- Amounts treated as taxable compensation to employee
- Amounts reimbursed under a reimbursement or other expense allowance arrangement
- Recreational or social activities or facilities primarily for employees (except highly compensated employees)

- Expenses directly related to business meetings of employees, stockholders, agents, or directors (not applicable to the 50% limitation)
- Expenses directly related to and necessary to attend a business meeting or convention of a business league, chamber of commerce, or real estate board (not applicable to 50% limitation)
- Available to the general public (e.g., night club, amusement park)
- Entertainment (including use of facility) sold to customers in bona fide transactions for adequate consideration (e.g., social club)
- Goods, services, or facilities taxable to a nonemployee as compensation for services or as a prize or award.

Meals before tax reform: Sections 274(k) and (n)

Business meals could not be lavish or extravagant, and the taxpayer or employee had to be present (Section 274(k)). Only 50% of expenses for food and beverages were deductible (Section 274(n)), with exceptions for:

- De minimis fringe benefits
- Taxable reimbursement to employees for meals incurred as a moving expense
- Meals provided to crew members of certain commercial vessels
- Meals provided on an oil or gas platform or drilling rig offshore or in Alaska
- Individuals subject to federal hours of service limitations and away from home (80% deductible).

Deductible meals had to be substantiated under Section 274(d) if a travel expense or entertainment.

Fringe benefits before tax reform: Sections 119 and 132

Under Section 119, the value of meals and lodging furnished to an employee for the convenience of the employer on business premises (lodging, only if a condition of employment) was excluded from the employee's income.

Under Section 132, fringe benefits provided or reimbursed were excluded from the employee's income. These included:

- Benefits provided at no additional cost
- Employee discounts
- Working condition fringe benefits (would be deductible employee business expense)
- De minimis benefits (occasional, value so small that accounting for it for employee is administratively impracticable, such as donuts); if connected with an eating facility, must be on or near business premises and revenue must equal or exceed direct operating costs
- Transportation (parking, transit passes, commuting in commuter highway vehicle, qualified bicycle commuting)
- Moving expenses that are otherwise deductible
- Retirement planning services
- Benefits related to military base realignment or closure.

Changes under tax reform: In general

Under Section 274(a), there is no deduction for expenses for entertainment activities or facilities, and no deduction for transportation fringe benefits.

Section 274(l) disallows a deduction for paying or reimbursing employee commuting expenses (other than qualified bicycle commuting reimbursement for 2018 through 2025).

The de minimis fringe benefit exception to the Section 274(n) 50% deduction limitation has been removed.

Under Section 274(o), there is no deduction for amounts paid or incurred after December 31, 2025, for costs of operating an employer-provided eating facility and for associated food and beverages, including benefits treated as de minimis fringes, or for expenses for meals provided for the convenience of the employer under Section 119(a).

Regarding fringe benefits, the employee exclusion for qualified bicycle commuting and qualified moving expense fringes has been suspended for 2018 through 2025. Other fringe benefits (including Sections 119(a) and 132) are still excluded from employees' income if applicable requirements are met.

Entertainment

Entertainment disallowed

Some entertainment is now subject to disallowance. Regulations defining entertainment still apply to identify disallowed expenses, using an objective test: activity of a type considered to constitute entertainment, amusement, or recreation. This may include activity that satisfies personal needs, such as providing food and beverages, and excludes activities clearly not considered entertainment. The Section 274(e) exceptions still apply.

The IRS states it is drafting on regulations in this area. Notice 2018-76 requests comments.

Entertainment treated as taxable compensation under Section 274(e)(2)

The general rules require including value of benefit in income, unless an exception applies.

For the cost of a flight on a company aircraft, the value generally is the SIFL rate. There is a special rule for use of company aircraft for entertainment of a specified individual (an officer, director, or more-than-10% owner). The exception to disallowance applies only to the extent of the amount of expenses included in the specified individual's income.

Meals

Business meals

The treatment of business meals in light of the entertainment expense deduction disallowance is unclear: Are business meals considered entertainment and thus disallowed?

Observation: The regulations sometimes discussed meals in the context of entertainment, but the retention of Section 274(k) (rules for deducting meals) seems to indicate meals are not inherently entertainment. If they are not entertainment, it is unclear which substantiation standard applies: Section 274(d) or Section 162.

Notice 2018-76 provides interim guidance on which taxpayers may rely pending issuance of regulations. The forthcoming proposed regulations will address when meal expenses are and are not entertainment.

Under the Notice, business meal expenses are deductible (subject to 50% disallowance) if the meal is:

- An ordinary and necessary business expense
- Not lavish or extravagant
- The taxpayer or an employee is present
- Provided to current or potential business customer, client, consultant, or similar contact
- If provided at an entertainment activity, the meal is purchased or stated separately from entertainment cost (not inflated).

Business meals: substantiation

Section 274(d)'s more stringent substantiation requirements apply to expenses for travel, entertainment, gifts, and listed property; that provision does not specify business meals as subject to increased substantiation. Meals are subject to Section 274(d) if travel or entertainment.

Observation: Notice 2018-76 does not address substantiation. However, the Notice's treatment of some business meals as not entertainment, and the failure of Section 274(d) and the regulations thereunder to address substantiation of business meals when not part of travel or entertainment, suggest that the Section 162 substantiation standard may apply.

De minimis fringes

De minimis fringes are excluded from employees' income under Section 132 but no longer excepted from the Section 274(n) 50% disallowance for food and beverages. The cost of providing donuts or pizza and soda at meetings is now 50% disallowed. Like other food and beverage expenses subject to Section 274(n), such costs are excepted from 50% disallowance only if Sections 274(e)(2), (3), (4), (7), (8), or (9) applies.

Employer-provided eating facilities

Providing meals for employees at an employer-provided eating facility is treated as de minimis fringe excluded from employee's income if provided on or near the employer's business premises and revenue equals or exceeds direct operating costs.

Even if the conditions for de minimis fringe are satisfied, the cost of food and beverages provided at an employer-eating facility (like other de minimis fringes) no longer is excepted from Section 274(n) 50% disallowance (except under Sections 274(e)(2), (3), (4), (7), (8), or (9)). The Section 274(e)(1) exception for food and beverages and eating facility costs is not an exception to Section 274(n).

Beginning in 2026, Section 274(o) will disallow deductions for operating costs, including food and beverage expenses, of employer eating facilities and for the cost of meals provided for the benefit of the employer under Section 119(a). There are no exceptions to Section 274(o).

Observation: When participants in the July 30 webcast were asked whether their company provides an eating facility for employees, 56% said they do not provide an eating facility for employees ; 23% said they provide an eating facility for employees and it qualifies as a de minimis fringe benefit; and 21% said they provide an eating facility for employees but it does not qualify as a de minimis fringe benefit.

Transportation fringe benefits

In general

Transportation fringe benefits up to $265/month (for 2019) are excludable from an employee's income under Section 132. Section 274(a)(4) disallows the employer's deduction for costs. Section 512(a)(7) requires tax-exempt organizations to treat the

amount disallowed under Section 274 as unrelated business taxable income (UBTI).

Section 274(l) disallows any expense for providing or reimbursing transportation for employee commuting, although not a transportation fringe, unless necessary to ensure employee safety. This applies even if the amount is taxable to the employee. It may apply to high-cost commuting (e.g., flying CEO to residence and back on weekends).

Employee safety is based on the facts and circumstances (e.g., high crime area during time of normal commute).

Whether depreciation is an expense for commuting is unclear; there is no guidance on Section 274(l) yet.

Observation: When participants in the July 30 webcast were asked whether their company provides transportation fringe benefits to employees or pays for employees' commuting expenses, 46% said they do not provide transportation fringe benefits or pay for commuting expenses; 35% said they provide transportation fringe benefits but do not pay for commuting; 9% said they provide transportation fringe benefits and pay for commuting only for certain senior employees; and 9% said they pay for commuting for some or all employees but do not provide transportation fringe benefits.

Qualified parking expenses

The qualified parking fringe is a type of qualified transportation fringe. The employer provides parking to an employee on or near the business premises or locations from which employee commutes via commuter highway vehicle or carpool. It does not cover parking on or near an employee's residence.

Notice 2018-99 provides interim guidance on which taxpayers may rely pending issuance of regulations, defining expenses and determining the amount disallowed (or treated as UBTI for tax-exempt organizations).

As to whether Section 274(e) exceptions should apply. Notice 2018-99 applies Section 274(e)(2) (treated as compensation to employees) and Section 274(e)(7) (items available to the public).

Observation: When participants in the July 30 webcast were asked whether their company provides free parking for employees at their business location or a location from which employees commute, 27% said they do not; 26% said they do and there are reserved employees spots and reserved spots for non-employees; 13% said they do and the only reserved spots are for employees; 12% said they do and the only reserved spots are for non-employees; and 23% said they do but there are no spots reserved for either employees or non-employees.

Determining the amount of qualified parking expenses under Notice 2018-99

If the taxpayer pays a third party for employee parking, the amount is the total annual cost. Amounts exceeding the exclusion limitation ($265 per month per employee for 2019) are taxable to the employee, so any expenses exceeding the limitation amount are deductible.

If the taxpayer owns or leases a parking facility, the amount is determined using any reasonable method. 'Parking facility' includes garages, parking lots, and other places where employees may park, on or near the business premises or commuting location, but not the employee's residence.

Taxpayers may aggregate expenses for multiple parking facilities in the same geographic location but not for parking facilities in different geographical locations.

Parking expenses include expenses for repairs, maintenance, utilities, insurance, property tax, snow/ice/leaf/trash removal, cleaning, landscaping, attendant pay, security, rent or lease payments (or portion if not separately stated).

Observation: Currently, there is no guidance on allocation methods.

Reasonable methods for owned or leased facilities

Safe harbor reasonable method:

Step 1: Identify parking spots exclusively reserved for employees and what percentage those are of total spots; multiply total parking expenses by that percentage; this amount is disallowed.

Step 2: After excluding reserved employee parking spots, determine if primary use (over 50%) of remaining spots is to provide parking to the general public; if so, all remaining expenses are excepted from disallowance under Section 274(e)(7).

Step 3: If primary use of remaining spots is not parking for the general public, identify spots exclusively reserved for non-employees and what percentage those are of total spots; multiply total parking costs by that percentage; this amount is not qualified parking and not disallowed.

Step 4: For expenses not categorized as allowed or disallowed under Steps 1-3, reasonably determine the amount of employee use during normal business hours on a typical business day to allocate an amount of the uncategorized expenses to employee parking.

Not reasonable methods: Basing disallowance on value of employee parking instead of expenses, and

failing to allocate expenses to reserved employee spots.

The takeaway

There is still a fair amount of uncertainty about how business meals will be treated under the Act. Until regulations are issued, taxpayers should continue to follow Notice 2018-76. Now may be a good time for taxpayers to review their general ledger accounting and try to align those accounts with the new rules.

Because of the new meal rules and the total disallowance of expenses for employer-provided eating facilities that goes into effect in 2026, employers may wish to review their policies on providing employee meals and/or eating facilities.

The new parking expense rules are confusing. Taxpayers should use their best efforts to determine reasonable methods, perhaps using statistical sampling, and document the method.

Let's talk

If you would like to discuss how these developments may affect your business, please contact:

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