

Proposed regulations clarify rules for business entertainment and meal expense deductions

March 12, 2020

In brief

The 2017 tax reform act (the Act) significantly limited the trade or business expense deduction for meals and entertainment by generally disallowing deductions for business entertainment expenses and removing the de minimis fringe benefit exception to the 50% deduction disallowance for meal expenses. These amendments apply to expenses paid or incurred after December 31, 2017.

The IRS and Treasury have published proposed regulations interpreting these rules. The regulations are proposed to apply for tax years beginning on or after the date of publication of final regulations. The preamble to the proposed regulations provides that, pending publication of final regulations, taxpayers may rely on the proposed regulations and on earlier interim guidance in Notice 2018-76 for expenses paid or incurred after December 31, 2017. For additional information on Notice 2018-76, see [IRS provides guidance on treatment of business meal expenses under tax reform](#).

In detail

Background

Entertainment

Before tax reform, Section 274(a) imposed a stricter deduction standard on expenses for entertainment activities than the general Section 162(a) 'ordinary and necessary' requirement for trade or business expenses and disallowed deductions for expenses for entertainment facilities. The Act generally disallows deductions for business entertainment expenses.

The existing regulations define entertainment as activity of a type considered to constitute entertainment, amusement, or recreation, including some activities that satisfy personal needs, such as providing food and beverages to an individual. Whether an activity is entertainment is determined under an objective test that considers the taxpayer's trade or business. For example, attending a play generally is entertainment, but it is not entertainment for a professional theater critic attending in a professional capacity.

Meals

Under Section 274(k), trade or business expenses for food or beverages (meals) are deductible only if not lavish or extravagant and the taxpayer or an employee is present.

The disallowance of entertainment expenses under the Act raised the issue of whether meal expenses are a form of entertainment and also disallowed. Notice 2018-76 clarified that meals are not entertainment generally, and allowed taxpayers to deduct business meal expenses, subject to the 50% disallowance, if the meal is:

- 1) An ordinary and necessary business expense,
- 2) Not lavish or extravagant,
- 3) With the taxpayer or an employee present,
- 4) Provided to a current or potential business customer, client, consultant, or similar contact, and
- 5) If provided at an entertainment activity, purchased or stated separately from the entertainment cost and not inflated.

Section 274(n) 50% deduction disallowance

Before the Act, Section 274(n) applied a 50% deduction disallowance to expenses for entertainment and for food or beverages unless an exception applied. The Act deleted entertainment expenses from Section 274(n) and removed an exception for expenses for food and beverages that are de minimis fringe benefits. Thus, although de minimis fringe benefits continue to be excludable from an employee's income, an employer's expenses for food or beverages provided as de minimis fringe benefits is subject to the 50% disallowance.

Section 274(e) exceptions

Section 274(e) provides nine exceptions to the Section 274(a) disallowances:

- 1) Food and beverages provided on an employer's business premises that primarily are for employees;
- 2) Expenses treated as compensation to employees;
- 3) Reimbursed expenses;
- 4) Expenses for recreational, social, or similar activities primarily for employees;
- 5) Expenses directly related to business meetings of employees, stockholders, agents, or directors;
- 6) Expenses directly related and necessary to attend a meeting of a tax-exempt business organization;
- 7) Items made available to the general public;
- 8) Goods or services sold to customers for adequate and full consideration in money or money's worth; and
- 9) Expenses treated as compensation to non-employees, such as independent contractors.

The exceptions in Sections 274(e)(2), (3), (4), (7), (8), and (9) also apply to the limitations on the deduction for food and beverage expenses under Sections (k) and (n).

Note: All nine Section 274(e) exceptions apply to Section 274(a), and the exceptions under Sections 274(e)(2), (3), (4), (7), (8), and (9) apply to Sections 274(k) and (n). Thus, before amendment by the Act, entertainment expenses that qualified for any Section 274(e) exception were not subject to the stricter deduction standard of Section 274(a). However, only expenses that qualified under Section 274(e)(2), (3), (4), (7), (8), or (9) were excepted from the Section 274(n) partial deduction disallowance. Thus, entertainment expenses within Section 274(e)(1), (5), or (6) were deductible if they qualified as trade or business expenses under Section 162, but the deduction was limited to 50%.

Observation: As amended, Section 274(a) generally disallows deductions for entertainment expenses, but entertainment expenses are no longer subject to Section 274(n). Thus, entertainment expenses within any of the nine Section 274(e) exceptions appear to be fully deductible.

Substantiation

Section 274(d) applies strict substantiation requirements for certain trade or business expenses. Expenses not subject to Section 274(d) generally must be substantiated under the less restrictive Section 162 requirements.

Prior to the Act, Section 274(d) applied to expenses for entertainment, travel away from home, gifts, and listed property. Section 274(d) did not apply to food and beverage expenses per se, but taxpayers generally treated meal expenses as subject to substantiation under Section 274(d) either as a form of entertainment or as an expense for travel away from home. The Act deleted entertainment expenses from Section 274(d).

Note: The Section 274(e) exceptions do not apply to Section 274(d).

Proposed regulations

Entertainment

The proposed regulations largely adopt the definition of entertainment, including the objective test, from the existing regulations, with variations only for style or to update usage (for example, substituting 'bars' for 'cocktail lounges').

Observation: The proposed regulations would include these definitional rules in a new Reg. sec. 1.274-11, but do not propose to amend or remove the corresponding definitions in Reg. sec. 1.274-2. Unless the final regulations conform the rules in these two sections, this approach may result in confusion for taxpayers to the extent the rules differ.

The proposed regulations confirm that the nine Section 274(e) exceptions continue to apply to expenses for entertainment otherwise disallowed under Section 274(a).

The preamble to the proposed regulations acknowledges that the Section 162 substantiation rules apply to allowable entertainment expenses, following the deletion of entertainment expenses from Section 274(d). The proposed regulations do not address the deletion of entertainment expenses from Section 274(n).

Meals

The proposed regulations essentially adopt the interim rules of Notice 2018-76 with some additions and clarifications in a new Reg. sec. 1.274-12.

In general

In defining entertainment, the proposed regulations clarify that food and beverages generally are *not* entertainment. Food and beverages provided during or at an entertainment activity generally *are* entertainment, however, unless purchased separately from the entertainment and separately stated on a bill, invoice, or receipt. The proposed regulations clarify that the amount charged for food and beverages must reflect the usual selling cost or approximate reasonable value.

For meal expenses not connected with an entertainment activity, the proposed regulations allow a taxpayer to deduct expenses that are ordinary and necessary business expenses and comply with Section 274(k) (not lavish or extravagant and the taxpayer or an employee is present), subject to the 50% disallowance. Consistent with Notice 2018-76, the food or beverages must be provided to a 'business associate,' which the proposed regulations define as a person the taxpayer may reasonably expect to deal with in the active conduct of the taxpayer's trade or business, such as a customer, client, supplier, and including a partner or employee, currently or in the future.

The definition of 'food and beverages' in the proposed regulations includes food and beverages treated as de minimis fringe benefits. 'Expenses' for food and beverages include costs incidental to providing meals, such as delivery fees, tips, and sales tax, but do not include costs such as salaries and overhead incurred in operating an employer eating facility.

Meals connected with travel

The proposed regulations apply the general rules for deducting meal expenses to meals paid or incurred while traveling away from home and confirm that, like other travel expenses, these meal expenses are subject to substantiation under Section 274(d).

Observation: The proposed regulations provide no rules for substantiating non-travel meal expenses. The preamble acknowledges that taxpayers must substantiate expenses for food and beverages not connected with travel away from home under the less restrictive Section 162 rules.

The proposed regulations incorporate rules under Section 274(m)(3) disallowing a deduction for meal expenses for a spouse, dependent, or other person accompanying an individual on business travel unless the spouse, dependent, or other person is the taxpayer's employee traveling for a business purpose and otherwise would be able to deduct the expenses.

Section 274(e) exceptions

The proposed regulations on entertainment expenses confirm that the nine Section 274(e) exceptions continue to apply to those expenses. The proposed regulations on food and beverage expenses largely incorporate the rules in Reg. sec. 1.274-2 interpreting the six Section 274(e) exceptions to Sections 274(k) and (n) and add certain clarifications.

- 1) A taxpayer may treat an expense as compensation only if it includes in the employee's income at least the amount required under the fringe benefit valuation rules in Reg. sec. 1.61-21. The Section 274(e) exception does not apply if the amount required to be included is zero.
- 2) Expenses for food or beverages provided to employees in a pantry or break room do not qualify for the exception for recreational or social activities although incidental socializing may occur there. Meals excludable from an employee's income under Section 119 as provided for the convenience of the employer also do not qualify for this exception because they are not provided for the benefit of the employee.
- 3) Food or beverages an employer provides to employees may qualify for the exception for items made available to the general public if they are similar to food and beverages the employer provides to, and are primarily consumed by, the general public. 'Primarily consumed' means more than 50% of reasonable estimated consumption. 'General public' includes customers, clients, and visitors, but does not include employees, partners, or independent contractors of the employer, or an exclusive list of guests.
- 4) For purposes of the goods and services sold to customers exception, adequate consideration in money or money's worth does not include providing services. However, meals a restaurant or catering business provides free of charge to its employees are within the exception. An employee also may be a 'customer' if the employee purchases food or beverages for a fair market value price.

Observation: The proposed regulations include these new interpretations of the Section 274(e)(2), (3), (4), (7), (8), and (9) exceptions in new Reg. sec. 1.274-12 and apply them only to food and beverage expenses, despite the fact that Sections 274(e)(2), (3), (4), (7), (8), and (9) also apply to entertainment expenses. Thus, the proposed regulations leave in place one set of rules interpreting Sections 274(e)(2), (3), (4), (7), (8), and (9) for meal expenses and another set of rules interpreting those provisions that apply to entertainment expenses. The proposed regulations provide no new interpretations of the Section 274(e)(1), (5), and (6) exceptions while confirming that those and the other Section 274(e) exceptions continue to apply to entertainment expenses.

The takeaway

The proposed regulations incorporate many rules from the current regulations and from Notice 2018-76. The proposed regulations and the preamble also provide some welcome clarifications, for example, that employer eating facility operating costs are not subject to the Section 274(n) partial disallowance and the Section 162 substantiation rules apply to allowable entertainment expenses and expenses for meals not connected with travel away from home. However, the structure of the proposed regulations creates new questions.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Federal Tax Services

Annette Smith, *Washington, DC*
(703) 405-8775
annette.smith@pwc.com

Specialized Tax Services

Brad White, *Los Angeles, CA*
(213) 356-6148
brad.white@pwc.com

Brian Daily, *Chicago, IL*
(708) 439-7309
brian.l.daily@pwc.com

Richard Farley, *New York, NY*
(646) 464-0707
richard.c.farley@pwc.com

Our insights. Your choices.

Make your preference selections to receive more content like this.

[Set your preferences today](#)

© 2020 PricewaterhouseCoopers LLP, a Delaware limited liability partnership. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

At PwC, our purpose is to build trust in society and solve important problems. PwC is a network of firms in 157 countries with over 276,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com/US.