



Taking a Tax Bite Out of Meal & Entertainment Expenses

Seven tips show you how to claim full deductions.

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One frustration encountered annually (and possibly quarterly) by CFOs and shareholders involves the realization that 50 percent to 100 percent of certain meals, entertainment and other related expenses are non-deductible and will increase taxable income, decrease cash flow and increase their effective tax rates.

Fortunately there are a number of exceptions to the general expense disallowance rules, which can allow taxpayers to deduct the full meal and entertainment expenditure on their federal and many state tax returns.

Certain industries such as professional service organizations, companies with multi-state or international operations and organizations with large sales forces, can incur significant meals and entertainment expenditures. While most businesses will break out meals and entertainment expenses by department, and/or general type of expense (e.g. meals, memberships, dues, etc.), corporations typically do not provide their CPAs with a level of detail of these expenses to allow a full analysis. This can result in over-deducting these expenses, or more likely, understating these expenses, based on overlooking the various exceptions, which can allow 100 percent deductibility.

The key to accurately determining the three general baskets of meal and entertainment expenses — 1) 100 percent deductible, 2) 50 percent deductible and 3) non-deductible — is full documentation of the business purpose, parties involved and a chart-of-accounts with sufficient detail to allow accurate classification.

General Rule

IRC Section 274(a)(1) states that no deduction is allowed for expenses associated with expenditures or facilities associated with “entertainment, amusement or recreation,” unless the taxpayer can support that the expenditure was directly related to a bona fide business discussion, business meeting or business convention. IRC Section 274(a)(1)(B), which addresses the deductibility of facility expenditures, provides that an allocation between deductible business and non-business expenses of facilities costs are necessary when there is mixed use.

Documentation Requirements

IRC Section 274(d) and Treas. Regs. Section 1.274-5 also provide for full disallowance of meals, entertainment and lodging expenses unless the taxpayer can substantiate the business purpose of the expenditure. The following details must be documented for each lodging and other expenditures in excess of \$75:

- the amount of expense,
- the time and place of the meal, entertainment, etc.,
- the business purpose of the expenditure,
- the business relationships of the various parties in attendance,

IRC Section 274(a)(2) and Treas. Regs. Section 1.274-2(a)(2) adds that no tax deduction will generally be allowed for membership payments for club dues, including dues to clubs organized for “business, pleasure, recreation or other social purpose.” This regulation applies to country club dues, health clubs and pure social clubs. Treas. Regs. Section 1.274-2(a)(2)(iii)(b) carves out exceptions for full deductibility in those cases where a taxpayer pays membership or ongoing dues to: “business leagues, trade associations, chambers of commerce, boards of trade and certain professional organizations (e.g. CPA societies, bar associations, etc.).”

Once a taxpayer has navigated around the general business vs. non-business provisions in IRC Section 274(a), other provisions must be evaluated to determine if an expenditure is 100 percent, 50 percent or non-deductible. IRC Section 274(n) applies a general 50 percent limitation on the deductible portion of “business related” meals and entertainment (other than the primarily non-deductible skybox expenditures and “event” tickets purchased at prices above the “face” amount on the ticket — IRC Section 274 (l)(2) and 275 (l)(1), respectively.

Interestingly Form 1120, Page 4, Schedule M-1, Line 5. c. lists the 50 percent taxable income add-back as “Travel & Entertainment” (vs. “Meals & Entertainment”) — further adding to the general taxpayer confusion as to which expenses are non-deductible, 50 percent deductible or fully deductible. **Note:** Lodging is generally fully deductible, with the exception of certain foreign or most cruise-based conventions/ meetings [see IRC Section 274(h)].

There are also numerous other exceptions, which can allow full deductibility of specified expenditures.

Specific Exceptions Allowing Full Deductibility

IRC Section 274(e) and (n) provide a number of situations where the 50 percent tax deduction scale-back will not be required. Following are the major exceptions that will allow the taxpayer to claim the full deduction:

- *De Minimis Fringe Benefit Amounts* — meals, entertainment and other employer-provided benefits that are relatively minor and difficult to track. Examples would include free soft drinks, snacks, etc. provided to office employees, as well as certain corporate picnics and similar events.

Note that more elaborate events where the cost per person is relatively high (e.g. a higher-end holiday party) may not fall within the *de minimis* exception.

- *Charitable-Sponsored Sporting Events* — tickets or packages involving sporting events where the proceeds are payable to a registered charity, and the event is staffed primarily by volunteers.
- *Employee Compensation Amounts* — to the extent the employer reports the meal or entertainment expenditure as W-2 income to employees other than “insiders,” the amount will be deemed fully deductible. For example, a team-building fishing lodge trip reportable to the participating employees will generally be fully deductible. Obviously not a popular option for the employee, but can often be very tax effective.
- *Reimbursed Expenses* — to the extent a corporation incurs such expenses on behalf of a client/customer and there is an adequate accounting of such expenditures, such expenses will generally be fully deductible.
- *Meetings of Business Leagues, etc.* — costs associated with various IRC 501 organizations.
- *Items Available to the Public or Sold to Customers* — trade show costs, receptions, etc. open to the general public, or seminars/conferences/entertainment/ etc. open to the general public or for which customers/clients pay for attendance.
- *Meals Provided to Certain Employees Working at Remote Locations* — including, oil platforms, vessels and certain long-haul truckers.

The fact that there are effectively three pools of meals and entertainment expenses to classify (100% deductible, 50% deductible and 100% non-deductible) makes it critically important for taxpayers to set up separate general ledger accounts to properly categorize the exact type of expense in order to quickly and accurately determine the tax deductibility of each item. Otherwise it is often difficult, if not impossible, for the corporate tax department or CPA firm to determine the proper tax treatment months or over a year after the expenses have been incurred. Many taxpayers simply end up adding back 50 percent of ALL meals and entertainment expenses for simplicity, or due to lack of understanding of the aforementioned rules.

With proper accounting systems in place, and a clear understanding of these rules, corporations can often reduce their after-tax meal and entertainment costs, improve cash flow and lower their effective tax rates.

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