



Tax Reduction Letter

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Notice 87-23

Meals, Entertainment, and Travel Expenses

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The Tax Reform Act of 1986 (the Act) made significant changes to the rules for deducting meals, entertainment, and travel expenses. These changes reduce the amount that may be deducted for certain expenses and limit the circumstances under which certain deductions may be taken. These changes generally are effective for taxable years beginning on or after January 1, 1987. The purpose of this notice is to alert taxpayers to these changes.

EIGHTY PERCENT LIMITATION ON MEAL AND ENTERTAINMENT EXPENSES

General Rules. The Act limits the amount allowable as a deduction for expenses for food and beverages (meals) and for other entertainment expenses to 80 percent of the amount that would otherwise be allowable as a deduction under the Internal Revenue Code (the Code).

This limitation in section 274 (n) of the Code generally is applied after determining the amount of the otherwise allowable deduction under section 162, which permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business, and other provisions of section 274, which disallow a deduction for certain entertainment expenses. In the case of a separately stated meal or entertainment expense incurred in the course of luxury water travel, however, the 80 percent limitation is applied prior to application of the limitation on luxury water travel expenses discussed below. If such meal expenses are not separately stated, the amount deductible under the luxury water travel limitation is not subject to the 80 percent rule. The 80 percent limitation is also applied prior to the application of the two percent floor on miscellaneous itemized deductions.

Exceptions to 80 Percent Limitation. Several exceptions apply to the 80 percent limitation.

First, an employer's expenses for meals and entertainment are not subject to the 80 percent limitation if the expenses are treated by the employer, with respect to the employee who is the recipient of the meals or entertainment, as compensation to the employee on the employer's tax return and as wages for purposes of withholding of income tax.

Second, an employee receiving reimbursement for expenses paid or incurred in connection with the performance of services for his or her employer under a reimbursement or other expense allowance arrangement with the employer is not subject to the 80 percent limitation, except to the extent that the employer has treated the expenses as compensation to the employee in accordance with the first exception. If the expenses are not treated as compensation to the employee, the employer making the reimbursement may deduct only 80 percent of reimbursed meal and entertainment expenses. Similarly, an independent contractor who accounts (to the

extent required by section 274 (d) of the Code) and is reimbursed for meals and entertainment expenses paid or incurred in connection with the performance of services for another person is not subject to the 80 percent limitation. For example, if a law firm separately accounts for meal and entertainment expenses as required under section 274 (d) and is reimbursed by a client, the law firm is not subject to the 80 percent limitation on these expenses. In such a case, however, the client is subject to the 80 percent limitation. If a law firm pays or incurs expenses for meals and entertainment in connection with providing services for a client but does not separately account for and seek reimbursement for such expenses, the law firm is subject to the 80 percent limitation on such expenses.

Third, expenses paid or incurred by the taxpayer for meals and entertainment are not subject to the 80 percent limitation if the expenses are includible in the gross income of a recipient of the meals or entertainment who is not an employee of the taxpayer as compensation for services rendered or as a prize or award, and the taxpayer includes such amount on a Form 1099 issued to the recipient.

Fourth, expenses for recreational, social or similar activities (including facilities for such activities) incurred primarily for the benefit of employees, other than certain highly compensated employees, are not subject to the 80 percent limitation. Thus, for example, the expenses of food, beverages, and entertainment for a company-wide summer party are not subject to the separate limitation.

Fifth, expenses for meals and entertainment, including the use of facilities, made available by the taxpayer to the general public, such as a free concert, are not subject to the 80 percent limitation.

Sixth, expenses for meals or entertainment sold by the taxpayer in a bonafide transaction for adequate and full consideration are not subject to the 80 percent limitation.

Seventh, the 80 percent limitation does not apply to an expense for food or beverage (but not entertainment) that is excludable from the gross income of the recipient under section 132 (e) of the Code, relating to de minimis fringe benefits. For example, an employer that operates an employee cafeteria for all its employees on its premises and charges amounts for its meals sufficient to cover the direct operating costs of the facility is not subject to the 80 percent limitation on its cafeteria expenses.

Eighth, the 80 percent limitation does not apply to the price of tickets to certain charitable sports events (including amounts in excess of face value) provided the expense is covered by a ticket package that includes admission to the event. To qualify, a charitable sports event must: (1) be organized for the primary purpose of benefiting a tax-exempt organization described in section 501 (c) (3) of the Code (e.g., a charitable or educational organization); (2) contribute 100 percent of its net proceeds to such organization; and (3) use volunteers for substantially all work performed in carrying out the event. For example, a golf tournament that donates all its net proceeds to charity is eligible to qualify under this exception, even if it offers prize money to the golfers who participate or uses paid concessionaires or security personnel. However, tickets to college or high school football or similar scholastic events generally do not qualify under this exception because they do not satisfy the requirement that substantially all work be performed by volunteers, if the institutions (or parties acting on their behalf) pay individuals to perform such services as coaching or recruiting.

Finally, an expense for food or beverages incurred before January 1, 1989, that is an integral part of a qualified meeting is not subject to the 80 percent limitation. A qualified meeting means a convention, seminar, annual meeting, or similar business program if: (1) an expense for food or beverage is not separately stated from the other qualified meeting expenses such as attendance at speeches or other program activities; (2) at least 40 individuals attend; (3) food and beverages are part of a program that includes a bona fide speaker; and (4) more than 50 percent of the participants are away from home (within the meaning of section 162 (a) (2) of the Code). For a program to satisfy the test for a qualified meeting, at least 40 individuals must attend the program, but not each event. Further, the speaker does not have to be present at the meal as long as the speaker speaks immediately before or after the meal. A good faith determination by the sponsor of a convention, seminar, annual meeting, or similar business program that the program satisfies the four requirements specified above will ordinarily be sufficient to substantiate the program as a qualified meeting for purposes of this rule. Thus, sponsors may make such determinations available to the participants.

Allocation of Single Sum Expenditures. A taxpayer may make one expenditure for goods and services consisting of food and beverage, entertainment, and other services (e.g., lodging or transportation) in situations that do not include a qualified meeting before January 1, 1989, and thus are not expected from the 80 percent limitation. For example, a hotel may include one or more meals in its room charge, or a company may provide its employees with one per diem amount to cover both lodging and meal expenses. In these cases, an allocation on a reasonable basis between the expenditures for food, beverages, and entertainment and the expenditures for other services is necessary. The Internal Revenue Service is exploring the feasibility of providing a mechanical test for the allocation of expenses that taxpayers would be able to use as an alternative to a reasonable allocation based on facts and circumstances.

Meals as Moving Expenses. The 80 percent limitation applies to meals that are deductible as moving expenses. If an employer reimburses moving expenses and does not treat the expense as compensation to the employee, then the employer is subject to the 80 percent limitation. If the employee is not reimbursed for the moving expenses or if a self-employed individual moves, then the employee or self-employed individual is subject to the 80 percent limitation.

OTHER LIMITATIONS ON MEAL EXPENSES

Business-Connection Requirement. Under the Act, deductions for meals are subject to the same requirements that apply to other entertainment expenses. Accordingly, an expense for food or beverages is not deductible unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business or, in the case of an item directly preceding or following a substantial and bona fide business discussion, that the item was associated with the active conduct of the taxpayer's trade or business. Thus, no deduction is allowable unless business is discussed directly before, during, or directly after the meal (except where an individual traveling away from home on business only claims a deduction for his or her meal). To be entitled to a deduction, the taxpayer also must substantiate the expense by adequate records or other sufficient evidence corroborating his or her own statement. These substantiation requirements are the same as those that apply to other entertainment expenses.

The exceptions to the business-connection requirement that apply to other entertainment expenses also apply to expenses for business meals. These nine exceptions are: (1) expenses for food and beverages furnished on the business premises of the taxpayer primarily for its

employees; (2) expenses that are treated by the taxpayer as compensation to the employee; (3) certain expenses paid or incurred by the taxpayer in connection with the taxpayer's performance of services for another person under a reimbursement or other expense allowance arrangement with such other person; (4) certain recreational expenses primarily for the benefit of employees; (5) expenses directly related to business meetings of the taxpayer's employees, stockholders, agents, or directors; (6) expenses directly related to and necessary to attendance at a business meeting or convention of certain tax-exempt business leagues and similar organizations; (7) expenses for goods, services, and facilities made available to the general public; (8) expenses for goods and services that are sold to customers; and (9) certain expenses for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee of the taxpayer as compensation for services or as a prize or an award.

Lavish or Extravagant Meals; Taxpayer Presence. Expenditures for food or beverages, whether or not incurred while the taxpayer is traveling in connection with business, are disallowed to the extent that they are lavish or extravagant. A determination of whether an expenditure is lavish or extravagant depends upon the facts and circumstances. Also, no deduction for food or beverage expenses is allowed unless the taxpayer (or an employee of the taxpayer) is present when food or beverages are provided. For purposes of this rule, an independent contractor who renders significant services to the taxpayer is treated as an employee if he or she attends the meal in connection with performance of such services.

These two additional restrictions do not apply to expenses treated as compensation; reimbursed expenses; recreational expenses for employees; items available to the public; meals sold to customers; and expenses includible in income of persons who are not employees.

State Legislators. In the case of a state legislator who has made an election under section 162 (h) of the Code, any excess of the amount allowable as a deduction under section 162 (h) for travel expenses away from home over the amount actually reimbursed to the legislator must be allocated between meals and other travel expenses in accordance with the ratio of meals and other travel expenses under the Federal per diem reimbursement rules for travel in the United States. Twenty percent of the amount of such excess allocated to meals is not deductible under the 80 percent limitation described above; the remaining 80 percent is deductible by itemizers as an employee expense subject to the new two percent floor under miscellaneous itemized deductions. For example, the current California per diem reimbursement for state legislators is \$75.00 per day. The current Federal per diem reimbursement for Sacramento is \$87.00 per day, of which \$54.00, or 62 percent, represents the lodging allowance and \$33.00, or 38 percent, represents the meals allowance. For each legislative day, a legislator would include \$75.00 in income. While \$87.00 would be deductible under section 162 (h), the application of the 80 percent limitation requires \$12.00 (the excess of \$87.00 over \$75.00) to be allocated between meals and other travel expenses. Thirty-eight percent of \$12.00, or \$4.56, would be allocated to meals and 20 percent of \$4.56, or \$.91, would not be deductible.

OTHER LIMITATIONS ON ENTERTAINMENT EXPENSES

Face Value Limitation for Tickets to Entertainment Events. The Act limits the amount of the deduction for a ticket to an entertainment event to the face value of the ticket. For example, amounts in excess of face value paid to scalpers, ticket agencies, and ticket brokers are not deductible. An exception from this requirement is provided for charitable sports events

(described above) that are excluded from the 80 percent limitation on the deduction of entertainment expenses.

Rentals of Skyboxes or Other Private Luxury Boxes. Under the Act, if a taxpayer rents a skybox for more than one event during a taxable year, the amount allowable as a deduction with respect to such events (including the first event) shall not exceed the face value of nonluxury box seat tickets generally held for sale to the public multiplied by the number of seats in such box. In determining whether a taxpayer has rented a skybox for more than one event, a single game or other performance counts as one event. Thus, a rental of a skybox for a series of games, such as the World Series, counts as more than one event. Also, all skybox rentals by the taxpayer in the same arena, along with any rentals by related parties, are taken into account in making this determination. Until further guidance is provided, the Internal Revenue Service will interpret related parties to mean members of the same family (spouses, ancestors, lineal descendants); corporations that are members of the same controlled group of corporations as defined in section 1563 (a) of the Code, determined without regard to section 1563 (a) (4) or section 1563 (b) (2), but substituting more than 50 percent for at least 80 percent each place it appears in section 1563 (a); a partnership and any of its principal partners (as defined in section 706 (b) (3)); a corporation and a partnership if the same person or persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership; and parties who have made one or more reciprocal arrangements with the taxpayer involving sharing skyboxes.

This restriction will be phased in over a 3-year period. The amounts disallowed for taxable years beginning in 1987 and 1988 are, respectively, one-third and two-thirds of the amounts that would be disallowed if the provision were fully effective in those years. For example, if a taxpayer paid \$740 for a skybox containing ten seats at each of two events in 1987, and the cost of ten nonluxury box seat tickets for each event is \$200, the taxpayer would be allowed a total deduction for \$896 for the two events (80 percent of \$400 plus 80 percent of 2/3 of \$1,080). If, however, the taxpayer had only rented the skybox for one event in 1987, the taxpayer would be allowed a deduction of \$592 (80 percent of \$740) for that skybox.

If expenses for food and beverages are separately stated, such expenses may be deducted in addition to the amount allowed as a deduction for the skybox, subject to other applicable requirements and limitations (e.g., the 80 percent limitation, the business connection requirement, and the prohibition on deduction of lavish and extravagant expenses). However, amounts separately stated for food and beverages must be reasonable. Thus, the skybox rental disallowance rule may not be circumvented by inflating the amounts charged for food and beverages.

TRAVEL EXPENSES

Luxury Water Transportation. The Act limits the amount of any otherwise allowable deduction for costs of cruise ship or other luxury water transportation to twice the highest Federal per diem generally available to employees of the Federal Government for travel in the United States, times the number of days in transit. For example, the highest Federal per diem is presently \$126 so a taxpayer's deduction for a five day trip cannot exceed \$1,260 ($2 \times \$126 \text{ per diem} \times 5 \text{ days}$). The Federal per diem rates are established by the General Services Administration and are revised periodically. The per diem limitation does not apply with respect to expenses allocable to cruise

ship conventions (which remain subject to the provisions of section 274 (h) (2) of the Code), or where an exception to the 80 percent limitation applies.

Travel as a Form of Education. The Act provides that no deduction is allowed for expenses for travel that otherwise would be deductible only on the ground that the travel itself constitutes a form of education. For example, this provision disallows deductions by a French teacher who travels to France to maintain general familiarity with the French language and culture.

Travel Expenses for the Performance of services to Charitable Organizations. The Act, in amending section 170 (k) of the Code, also provides that no deduction is allowed for transportation and other travel expenses relating to the performance of services away from home for a charitable organization unless there is no significant element of personal pleasure, recreation, or vacation in the travel. For example, a taxpayer who sails from one Caribbean Island to another and spends eight hours a day counting whales and other forms of marine life as part of a project sponsored by a charitable organization generally will not be permitted a charitable deduction. By way of further example, a taxpayer who works on an archaeological excavation sponsored by a charitable organization for several hours each morning, with the rest of the day free for recreation and sightseeing, will not be allowed a deduction even if the taxpayer works very hard during those few hours. In contrast, a member of a local chapter of a charitable organization who travels to New York City and spends an entire day attending the organization's regional meeting will not be subject to this provision even if he or she attends the theatre in the evening. This provision applies whether the travel expenses are paid directly by the taxpayer or by some indirect means such as by contribution to the charitable organization that pays for the taxpayer's travel expenses. Amounts paid prior to January 1, 1987 to a fund that is to be used to finance non-deductible travel after December 31, 1986 are generally nondeductible.

Travel as an Investment-Related Expense. The Act provides that no deduction is allowed for travel or other costs of attending a convention, seminar, or similar meeting unless the activity relates to a trade or business of the taxpayer. For example, registration fees, travel and transportation costs, and meals and lodging expenses incurred in connection with attending an investment seminar or similar meeting relating to investments, financial planning, or other activities for the production or collection of income are not deductible.

EFFECTIVE DATES

In General. The changes made by the Act to the rules regarding deductions for meal, travel and entertainment expenses are effective for taxable years beginning after December 31, 1986.

Special Rules for Partnerships and S Corporations. In the case of a partnership or an S corporation, deductions for meals, travel, and entertainment expenses are reflected in the taxable income of a partner or shareholder for the taxable year with which or within which the taxable year of the partnership or S corporation ends. Under section 702 (a) (7) of the Code, in the case of a partnership, and section 1366 (a) (1) (A), in the case of an S corporation, expenses that are subject to provisions of the Act should be accounted for separately in certain years, since these items will affect the tax liability of partners and shareholders if separately stated in such years. For example, a partnership with a fiscal year ending June 30, 1987 should separately state meal and entertainment expenses incurred during such taxable year (including amounts incurred prior to January 1, 1987) and such amounts should be subject to the new rules, such as the 80 percent limitation, with respect to partners with taxable years beginning on or after January 1, 1987.

Accordingly, the changes made by the Act should apply to expenses incurred by partnerships or S corporations for taxable years ending after December 31, 1986, with respect to partners and S corporation shareholders whose taxable years begin on or after January 1, 1987.

However, because the application of the effective date provisions to partnerships and S corporations may impose substantial administrative burdens on taxpayers, the Internal Revenue Service will not apply the new rules to meal, travel and entertainment expenses of partnerships and S corporations that are paid or incurred before January 1, 1987. Thus, the regulations under sections 702 (a) (7) and 1366 (a) (1) (A) of the Code will require partnerships and S corporations to separately state expenses paid or incurred after December 31, 1986 by partnerships or S corporations that have taxable years beginning before January 1, 1987 and ending with or within partners' or shareholders' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals (subject to provisions of the Act) separate statement will be required for rents paid or incurred after December 31, 1986 by partnerships or S corporations that have taxable years beginning before January 1, 1989 and ending with or within partners' or shareholders' taxable years beginning on or after January 1, 1987.