OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated May 3, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

ISSUE(S):

How should the limitation on entertainment expense deductions provided by I.R.C. § 274(n) be applied to entertainment expenses incurred by X's employees at X-operated facilities and reimbursed by X under an accountable plan?

CONCLUSION:

Because X reimburses its employees for meal and entertainment expenses under an accountable plan, X may deduct only 50 percent of the amount reimbursed.

FACTS:

X is involved in a number of business enterprises, including the operation of various restaurants. If an X employee needs to entertain a business client in furtherance of one of X's business enterprises, the employee may take the client to an X-operated restaurant. The employee pays the bill, including taxes and tips, with cash or credit card, and subsequently the employee submits a voucher (indicating the amount, time, place, business purpose of the entertainment, and the business connection of the person entertained) and receipts to X for reimbursement. X treats the reimbursements as made pursuant to an accountable plan, and the payments are not treated as wages to the employees. X has not indicated that the restaurant treats the amounts paid by the employee for the bill differently from any other customer's bill payment.

In preparing its consolidated federal income tax returns for the years at issue, X adjusted its direct costs (e.g., the costs of food supplies) purportedly to take into account the limitation on deductions under section 274(n). X compared the total sales price of the employee's bill to the total sales of the restaurant, and then applied this ratio to the direct costs at the restaurant to determine the amount subject to the section 274(n) limitation. For example, if the bill for a business-related meal, exclusive of taxes and tips, was $50, comprising $25 for allocable direct costs, $20 for allocable indirect costs, and $5 profit, X would apply the section 274(n) limitation only to the $25 allocable direct costs.

In prior examination cycles, the examination division adjusted X's meal and entertainment expense by applying the limitation to the direct cost of supplies as well as to the indirect costs, such as preparation and facility costs. Thus, in the example in the previous paragraph, the examination division would apply the section 274(n) limitation to both the $25 allocable direct costs and the $20 allocable indirect costs. Neither X nor the examination division took into account X's profit or taxes and tips in determining the amount to which the section 274(n) limitation should be applied.

LAW AND ANALYSIS

Section 162(a) generally allows a deduction for all the ordinary and necessary expenses paid or incurred in carrying on any trade or business. However, section 274(n) currently provides that the amount allowable as a deduction for any expense for food or beverages, or for entertainment, shall not exceed 50 percent of the amount of the expense that would be otherwise allowable as a deduction.

In originally enacting section 274, Congress was concerned about potential abuses resulting from entertainment expense deductions. Limitations were placed on entertainment expense deductions because these expenses, even though having an association with the needs of business, confer substantial tax-free personal benefits on the recipients. See H.R. Conf. Rep. No. 2518, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 401, 423-430. The Tax Reform Act of 1986 added section 274(n) to further prevent abuses, limiting business entertainment and meal deductions to 80 percent of the amount otherwise allowable as a deduction. The limitation was later reduced to 50 percent for taxable years beginning after December 31, 1993, by the Omnibus Budget Reconciliation Act of 1993.

Pursuant to the accountable plan rules under section 62(a) and (c), and Treas. Reg. §1.62-2 of the Income Tax Regulations, reimbursements paid to employees are treated as paid under an accountable plan only if the specified requirements are met. One of the requirements is that the reimbursements must be paid for expenses that are deductible as business expenses under part VI, which includes section 162(a). If this requirement is not met, the reimbursement is treated as wages includible in the employee's gross income and subject to the employment tax provisions (including FICA taxes, FUTA taxes, and federal income tax withholding); however, in this situation the section 274(n) limitations would not apply. See section 274(n)(2)(A) and (e)(2).

An initial concern in this case is whether section 274(n) limitations may be properly applied to the allocable direct costs, as done by both X and the examination division. The Tax Court has consistently held that the cost of goods sold is not a deduction (within the meaning of section 162(a)), but is subtracted from gross receipts in the determination of a taxpayer's gross income. See Max Sobel Wholesale Liquors v. Commissioner, 69 T.C. 477, aff'd, 630 F.2d 670 (9th Cir. 1980); see also Beatty v. Commissioner, 106 T.C. 268 (1996). Thus, because the allocable direct costs are costs of goods sold, they are not a deduction susceptible to the limitations provided by section 274(n). In addition, even if costs of goods sold were susceptible to these limitations, section 274(n)(2)(A), (e)(7), and (e)(8) may provide exceptions to the application of the limitations.

This does not, however, end the inquiry. Rather than focusing on the patronage by an X employee of an X-operated restaurant (which apparently does not differ significantly from the patronage of any other customer) the proper analysis should focus on the subsequent reimbursement by X of the expenses incurred by the X employee. As stated above, X has established an accountable plan to reimburse business expenses incurred on its behalf by its employees. When an employee entertains a customer at an X-operated facility, X reimburses this expense as an expense incurred pursuant to X's trade or business. X does not treat the

reimbursement as wages paid to an employee, and therefore the exception to the section 274(n) limitations under section 274(n)(2)(A) and (e)(2) does not apply. Clearly this is X's entertainment expense, and this is the type of expense Congress intended to limit in enacting section 274(n).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We understand that this issue has gone to Appeals for the 1988-1989 and prior cycles. These cycles have been closed out with Appeals conceding the entire adjustment amount on this issue as part of an overall settlement agreement. Currently, Appeals proposes that the section 274(n) limitation be applied to the menu price of the meal (including taxes and tips).

Examination is currently examining X's 1994-1996 returns, taking the same position as in prior examinations that the section 274(n) limitations apply to allocable direct and indirect costs.

[redacted]

If you have any further questions, please call (202) 622-7920.

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