

Case Study of the Deductibility of Business Meal Expenses

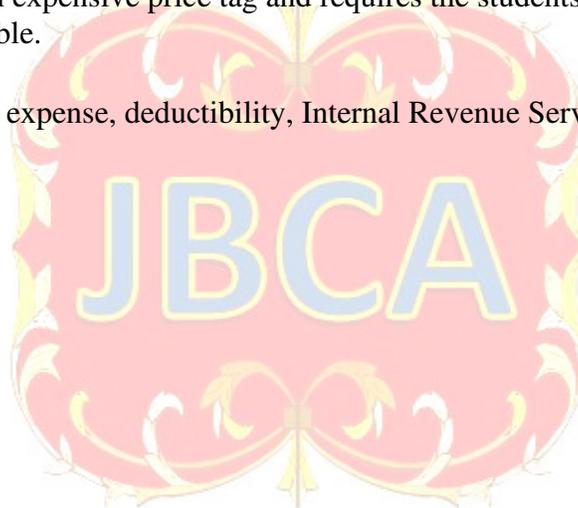
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ABSTRACT

This case study involves an analysis how Federal Income Tax law affects business meal expenses for client entertaining. American businesses spend 50 to 60 billion dollars annually on business meals. The Tax Cuts and Jobs Act of 2017 altered the treatment of business entertainment expenses significantly. The case examines whether business meals remain tax deductible and if so, under what conditions. The case setting involves a luxurious dinner in an upscale restaurant with an expensive price tag and requires the students to determine whether the meal's cost is tax deductible.

Keywords: business meal expense, deductibility, Internal Revenue Service Notice 2018-76, lavish or extravagant



INTRODUCTION

Background

Americans have a real appetite for dining in restaurants. The National Restaurant Association estimated we spent 863 billion dollars in restaurants in 2019 (Vojinovic, 2021). American business also has a significant appetite for business dining. Recent estimates range from annual costs of 50 to 60 billion dollars spent by business providing business meals for customers and employees (“Study Shows”, 2016 and Lenzmeir, 2018).

Yet the Tax Cuts and Jobs Act of 2017, enacted into law on December 22, 2017, may have fundamentally changed the way to account for business meal expenditures for income tax purposes. Tax deductions for business entertainment expenses were eliminated by this Act. Commentators questioned whether this elimination also eliminated the deduction for business meal expenses.

This case examines the Federal Income Tax treatment of business meal expenses subsequent to the Tax Cuts and Jobs Act of 2017. More specifically, it ponders if, and under what conditions, a very expensive business meal consumed in an upscale setting can be deducted on a Federal Income Tax return.

Although the landscape surrounding the deductibility of entertainment expenses has changed greatly since the adoption of Tax Cuts and Jobs Act of 2017, students should be able to discern if business meals continue to be deductible expenses under the Internal Revenue Code. A more difficult question to answer is whether an extraordinarily expensive meal served in a world class restaurant like Manny’s remains deductible. If the students are willing to dig deeply in their tax research, they should uncover a 1963 ruling by the Internal Revenue Service providing them a sound basis for their conclusion that the expense for the meal is deductible.

THE CASE PRESENTED TO STUDENTS

The Case Situation

Assume you are part on an engagement team at a big four accounting firm located in Minneapolis, Minnesota. Your engagement team focuses its work in the merger and acquisition arena. You have just completed a major acquisition for an important client in which the client invested \$75,000,000 of capital to acquire a competitor. The engagement principal at your firm invites you and your spouse, along with all other engagement team members, their guests and the client’s management team and guests, to a celebratory dinner at Manny’s Steakhouse® in downtown Minneapolis to celebrate the achievement. Fourteen people in total attend the dinner.

Your principal reserves the private dining room for the evening’s festivities. Guests begin arriving at 6 pm and are ushered into the private dining room. Introductions are made and conversations ensue along with cocktails of choice. Members of the engagement team and the client’s management team discreetly share observations, chuckles and a few laughs reliving humorous moments arising throughout the negotiations and due diligence periods. Professional/client relationships are further cemented by this dialogue and comradery. The evening is going well so far.

As the cocktail hour wanes, guests are seated and menus are distributed. A copy of Manny’s current menu is attached in Table 1 (“Appendix”). Guests peruse the extensive and

expensive dining options. Choices are made, drinks refilled and conversation continues to flow. Appetizers arrive. First time guests are amazed at the gargantuan size of the hors d'oeuvres. Their flavors match their size. Similar responses occur when the main courses appear. Steaks look like roasts, baked potatoes are the size of footballs, and lobsters range to three pounds. It's dining like you have never experienced. The quantity and quality of the food is utterly amazing.

And so is the cost. The engagement team principal shows you the tab for the evening. \$3,150 before gratuity of \$630. Total bill is \$3,780. You swallow hard and are glad that your credit card does not have to cover it.

After the magnificent dinner ended, the entire group headed to the Excel Center to see the Minnesota Wild hockey club play the Montreal Canadiens in a match. Fourteen tickets at \$100 a piece are added to the principal's Visa card. You wonder if any of these expenses are tax deductible?

QUESTIONS

1. Are client entertainment costs tax deductible after the Tax Cuts and Jobs Act of 2017 ("TCJA")?
2. Are business meals tax deductible after the TCJA?
3. Would the business meal at Manny's restaurant be considered deductible?

Answers:

1. Question 1 stated, "Are client entertainment expenses tax deductible after the Tax Cuts and Jobs Act of 2017 ("TCJA")?"

Internal Revenue Code Section ("Code") 162 provides a deduction for ordinary and necessary business expenses incurred in a trade or business. Historically, business entertainment expenses have long been held to be ordinary and necessary business expenses provided they met the requirements of Code Section 274(a)(1)(A). This section required business entertainment expenses to 1) be directly related to the active conduct of the taxpayer's trade or business or 2) must directly precede or follow a substantial and bona fide business discussion and be associated with the active conduct of the trade or business.

Code Section 274(a) was amended by the TCJA eliminating the directly related and business discussion requirements rendering business entertainment expenses nondeductible. "No deduction otherwise allowable under this chapter shall be allowed for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation..." Therefore, subsequent to the TCJA, business entertaining costs are no longer deductible.

For example, the \$1,400 cost of the tickets to attend the Minnesota Wild Hockey game after the dinner are not deductible under Code section 274(a), as those costs would be considered entertainment expenses.

2. Question 2 stated, “Are business meals tax deductible after the TCJA?”

Historically, business meals have been considered to be a form of business entertainment. See Treasury Regulation 1.274-2(b)(1)(i): “For purposes of this section, the term *entertainment* means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term *entertainment* may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family....”

If business meals are a form of entertainment, they are no longer deductible under Code Section 274(a), as amended by the TCJA. However, the TCJA also amended Code Section 274(k) which provides, “No deduction shall be allowed under this chapter for the expense of any food or beverage unless (A) such expense is not lavish or extravagant under the circumstances, and (B) the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages.” Code Section 274(n)(1) limits the deduction to fifty percent of the cost of the meal or beverage. There appears to be an apparent contradiction between Code Section 274(a) disallowing business entertainment expenses, and Code Section 274(k), appearing to allow deduction of business meals in limited circumstances- i.e., taxpayer is present at furnishing and expenses are not lavish or extravagant. Are meals and drinks provided for a client's employees nondeductible entertainment expenses per Code Section 274(a) or deductible business meals/beverages per Code Section 274(k)?

In Notice 2018-76, 2018 -42 IRB 599, 10/03/2018, the Internal Revenue Service offered guidance to the tax paying public on the deductibility of business meals in the post TCJA era. The Notice was intended to provide interim guidance until such time as it and the Treasury Department drafts proposed regulations. Initially, it noted the TCJA did not address whether business meals would be considered entertainment, and therefore, be non-deductible. The Internal Revenue Service looked to the legislative history of the TCJA to conclude the Act continued to support a deduction for business meal expenses. “Taxpayers may still generally deduct 50 percent of the food or beverage expenses associated with operating their trade or business.” H.R. Rep No. 115-446, at 407 (2017) (Conf Rep.).

A five-factor test was enunciated in Notice 2018-76 for the deductibility of business meals expenses. Fifty percent of the cost of a business meal will be deductible if: (1) the expense is an ordinary and necessary expense under Code Section 162, “(a) paid or incurred during the taxable year in carrying on a trade of business; (2) the expense is not lavish or extravagant under the circumstances; (3) the taxpayer or an employee of the taxpayer is present at the furnishing of the food or beverages; (4) the food or beverages are provided to a current or a potential business customer, client, consultant or similar business contact; (5) in the case of food or beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the cost of entertainment on one or more bills, invoices or receipts. The entertainment disallowance may not be circumvented through inflating the amount charged for food and beverages.”

This has been amplified by the Treasury Department's issuance of Proposed Regulation 1.274-12 on February 21, 2020. This proposed regulation updates the guidance contained in Notice 2018-76, which remains in force until final regulations are adopted by the Treasury Department. In an interesting move, The Treasury Department stated taxpayers may rely on either Notice 2018-76 or Proposed Regulation 1.274-12 as their guidance is essentially the same.

Proposed Regulation 1.274-12(a) states, "no deduction is allowed for food or beverages expenses provided by a taxpayer, or an employee of a taxpayer, to another person unless: (i) the expense is not lavish or extravagant under the circumstances, (ii) the taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages, and (iii) the food or beverages are provided to a business associate." A business associate is defined in proposed Regulation 1.274-12(b)(3) as a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business, such as customers, clients, etc.

3. Question 3 stated, "Would the business meal at Manny's restaurant be deductible?"

Let's apply the five-factor test of Notice 2018-76 to the Manny's dinner to determine whether one half of the \$3780 cost would be deductible.

- (1) Was the business meal at Manny's an ordinary and necessary business expense under Code Section 162 paid or incurred during the year in a trade or business? The U.S. Supreme Court defined ordinary and necessary business expense as customary or usual. *Welch-v-Helvering*, 12 AFTR 1456 (S. Ct. 1933). The furnishing of business meals for clients is customary practice in American business. It is without question an ordinary and necessary expense.
- (2) Was the meal lavish or extravagant in the circumstances? To the average citizen, a meal costing \$3780 would very likely be considered lavish or extravagant. Dining on two-pound steaks and three-pound lobsters is something few have experienced. The sheer dollar amount suggests excessiveness. The terms lavish or extravagant are not defined in Notice 2018-76 nor Treasury Reg. 1.274-1. The Internal Revenue Service examined questions on the limitation of business entertainment deductions under Code Section 274 and the Regulations promulgated thereunder in Revenue Ruling 63-144, 1963-2 CB 129. In question 42 it raised the following issue. "Will entertainment expenses be subject to disallowance on grounds of being lavish or extravagant merely because they exceed a fixed dollar amount or are incurred at deluxe restaurants, hotels, night clubs and resort establishments. Answer: No. An expense for entertainment will not be considered lavish or extravagant merely because it involves first class accommodations or services. An expense which, considering the facts and circumstances, is reasonable will not be considered lavish or extravagant." 1963-2 CB at 139.

Manny's is clearly a first-class restaurant. *Men's Journal* ranked it as among the ten best steakhouses in the world in 2015. The *Zagat Survey* has rated Manny's as one of the ten best steakhouses in America. This fact does not disqualify the \$3780 dinner. Nor would its cost, as the food and beverage were merely items selected from its standard menu.

Considering the facts and circumstances, the dinner was not lavish or extravagant. The deduction would be limited to one half of the meal's cost under Code Section 274(n)(1).

- (3) Was the taxpayer or an employee of the taxpayer present at the furnishing of the food or beverages? Yes.
- (4) Was the food or beverages provided to a current or potential customer, client, consultant or similar business contact? Yes, that was the point of the evening: to generate client goodwill.
- (5) If food or beverages were provided during or at an entertainment activity, was the food and beverages purchased separately from the cost of entertainment on one or more bills, invoices or receipts? There was no purchase of food or beverages at the Wild Hockey game. Therefore, there was no need to segregate the meal costs.

TEACHING NOTES

Learning Objectives and Suggested Use of the Case

The goal of this case study is for students to research and analyze how the changes in Federal tax law, arising from the Tax Cuts and Jobs Act of 2017, impact the deductibility of business meal expenses. The specific learning objectives of the case are for the students to:

1. distinguish between business entertainment expenses and business meal expenses;
2. determine under what circumstances business meal expenses are deductible;
3. determine if extraordinarily expensive meals are deductible as business expenses.

Course and Audience

This case should be suitable for intermediate and advanced undergraduate accounting students, as well as graduate students, provided they have experience conducting Federal tax research.

The delivery of the case is flexible and appropriate for either an in-person discussion or online discussion. The case could also be assigned as a tax case project which includes a research element, asking students to formulate their responses by researching the Internal Revenue Code, Treasury Regulations and related materials.

A pedagogical benefit of the case is it adopts a fact situation many of the students will experience in their future careers in accounting. In spite of the Tax Cuts and Jobs Act of 2017, business entertainment has not gone away. Students will find themselves in the very setting imagined in the facts of the case: sitting in a very upscale restaurant expected to entertain their business clients and guests.

CONCLUSION

The tax deductibility of business entertainment expenses has undergone significant change since the adoption of the Tax Cuts and Job Act of 2017. In general, the cost of business entertainment is no longer deductible. However, the question of business meals deduction was left unresolved by this Act. Much confusion ensued until the Internal Revenue Service promulgated Notice 2018-76 on October 3, 2018, which clearly allows deductibility, provided the taxpayer meets a five-factor test. The \$3,780 meal at Manny's restaurant, although incredibly expensive, should be deductible as an ordinary and necessary business expenditure. It was not lavish or extravagant within the meaning of Revenue Ruling 63-144, since it simply consisted of ordinary items ordered off Manny's standard menu available to all.

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AUTHOR INFORMATION

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APPENDIX

Table 1 See attached Manny’s menu.



APPETIZERS		SALADS	
MAINE LOBSTER CAKES	28.95	CAESAR*	15.95
RAW OYSTERS ON THE HALF SHELL *	25.95	HEARTS OF PALM	15.95
SHRIMP COCKTAIL	28.95	SLICED TOMATO AND MOZZARELLA	15.95
OYSTERS ROCKEFELLER	25.95	SLICED TOMATO AND ONION	15.95
APPLE SMOKED BACON	26.95	SPINACH	15.95
TENDERLOIN CARPACCIO*RAW	23.95	MIXED GREEN	15.95
SCALLOPS BENEDICT	26.95	WEDGE SALAD	15.95
PORTOBELLA FRIES	20.95	CHOPPED SALAD	16.95
SCALLOP AND SHORT RIB SLIDER	23.95		
ROASTED BONE MARROW	21.95		

MANNY'S SEAFOOD TOWER*		
SINGLE*	DOUBLE*	TRIPLE*
FOR 4 OR MORE	FOR 6 OR MORE	FOR 8 OR MORE
99.95	159.95	204.95

STEAKS	
NEW YORK STRIP STEAK*	79.95
PORTERHOUSE STEAK*	79.95
FILET MIGNON*	69.95
FILET MIGNON, LARGE*	79.95
DOUBLE CUT PRIME RIB*	62.95
NEW YORK STEAK SANDWICH*	38.95
BONE-IN RIBEYE*	79.95
BLUDGEON OF BEEF*	117.95
BASEBALL STEAK*	61.95
DOUBLE PORTERHOUSE*	117.95
BONE IN TENDERLOIN*	85.95

SEAFOOD	
WHOLE LIVE LOBSTERS	35.00/ PER LB
KING CRAB LEGS, 2LBS	113.95
NOVA SCOTIA LOBSTER TAIL	92.95
AHI TUNA STEAK*	42.95
SHRIMP SCAMPI	39.95
DEEP FRIED SHRIMP	39.95
THICK CUT SALMON*	39.95

CHOPS & OTHER	
LAMB CHOPS*	49.95
VEAL CHOPS*	48.95
LEMON MUSTARD CHICKEN	33.95
PORK CHOPS*	36.95
MANNY'S BURGER*	28.95

SIDE DISHES			
POTATOES (FOR THE TABLE)	VEGETABLES (FOR THE TABLE)		
LOADED MASHED POTATOES	19.95	ASPARAGUS/HOLLANDAISE*	19.95
HOUSE MADE CHIPS	10.95	BROCCOLI/HOLLANDAISE*	14.95
HASH BROWNS WITH/WITHOUT ONIONS	18.95	CREAMED GARLIC SPINACH	15.95
BAKED POTATO	10.95	SAUTEED MUSHROOMS	16.95
MACARONI AND CHEESE	17.95	FRENCH FRIED ONIONS	10.95
TRUFFLED FRENCH FRIES	10.95		

PANNA - OR - SAN PELLIGRINO 7.95

*PLEASE NOTE EATING RAW OR UNDERCOOKED MEAT, POULTRY, FISH, SEAFOOD OR EGG CAN INCREASE THE RISK OF FOODBORNE ILLNESS. THIS RISK INCREASES WITH SOME MEDICAL CONDITIONS.

To maintain quality benefit programs and Covid sanitation for our employees Manny's Steakhouse adds a 4% service charge to our guest checks. This is not an employee gratuity.

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