

Part I

Section 274.-- Disallowance of Certain Entertainment, Etc., Expenses

26 CFR 1.274-2: Disallowance of deductions for certain expenses for entertainment, amusement, recreation, or travel.
(Also §§ 62, 1.62-2.)

Rev. Rul. 2008-23

ISSUE

If a Client leases employees from a Leasing Company, and the Leasing Company reimburses the employees for meal and incidental expenses (M&IE) they incur in the course of performing services, which party's deduction for reimbursement of the M&IE is subject to the limitation under § 274(n) of the Internal Revenue Code?

FACTS

Leasing Company and Client, who are unrelated parties, enter into a written employee leasing contract under which Leasing Company leases drivers to Client to haul products in exchange for Client's periodic payments to Leasing Company. The employee leasing contract provides that Leasing Company will calculate Client's periodic payments to cover Leasing Company's expenditures (wages due to drivers,

payments of the M&IE to drivers under a reimbursement arrangement between Leasing Company and the drivers, and other expenses) plus a profit.

Each driver (Driver) performs services as an employee in the trucking industry. Driver incurs M&IE while traveling overnight away from home in connection with Driver's employment. In addition to receiving wages, Driver receives a separately stated reimbursement at the M&IE rate from Leasing Company. All the reimbursements paid to Driver are paid under a "reimbursement or other expense allowance arrangement," within the meaning of § 274(e)(3), between Leasing Company and Driver.

Neither Leasing Company nor Client deducts the M&IE amounts as compensation on its originally filed income tax return, nor does either treat the M&IE amounts as wages for purposes of withholding under Chapter 24. The employee leasing contract does not address which party reimburses the drivers' M&IE for purposes of applying the § 274(n) limitation. In each situation described below, either Leasing Company or Client may be the Driver's employer under the usual common law rules applicable to determining the employer-employee relationship. See § 31.3121(d)-1 of the Employment Tax Regulations.

Situation 1. Driver adequately accounts to Leasing Company for the M&IE to satisfy the substantiation requirements of § 274(d) pursuant to an annually updated revenue procedure, Rev. Proc. 2007-63, 2007-42 I.R.B. 809 (or any successor). After calculating Driver's wages and any M&IE payments that may be due, Leasing Company sends Client a billing invoice for a periodic payment due. The invoice is for a lump-sum and does not itemize for the amount of any M&IE reimbursement. Client pays Leasing

Company the lump-sum periodic payment. Upon receiving Client's periodic payment, Leasing Company pays both Driver's wages and M&IE reimbursement.

Situation 2. Driver adequately accounts to Leasing Company for the M&IE to satisfy the substantiation requirements of § 274(d) pursuant to Rev. Proc. 2007-63 (or any successor). After Driver accounts to Leasing Company for M&IE, Leasing Company calculates Driver's wages and any M&IE payments that may be due. Leasing Company sends Client a billing invoice for a periodic payment due. The invoice is for a lump-sum and does not itemize for the amount of any M&IE reimbursement. Client pays Leasing Company the lump-sum periodic payment. Upon receiving Client's periodic payment, Leasing Company pays both Driver's wages and M&IE reimbursement. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver as a reimbursement of Driver's M&IE. Leasing Company also accounts for that amount by delivering to Client a copy of all of the substantiation that Driver had originally submitted to Leasing Company. Client accepts the substantiation submitted by Leasing Company and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement with Leasing Company and is subject to the § 274(n) limitation.

Situation 3. Driver is paid an allowance at the applicable M&IE rate by Leasing Company, but substantiates the expenses to Client. Client then immediately delivers to Leasing Company a copy of all of the information that Driver had originally submitted to Client to substantiate Driver's expenses, and Client informs Driver that it has done so. Leasing Company accepts the substantiation. Driver adequately accounts for the M&IE

to satisfy the substantiation requirements of § 274(d) pursuant to Rev. Proc. 2007-63 (or any successor).

After receiving Driver's substantiation, Leasing Company calculates Driver's wages and any M&IE reimbursements that may be due. Leasing Company sends Client a billing invoice for a periodic payment due. The invoice is for a lump-sum and does not itemize for the amount of any M&IE reimbursement. Client pays Leasing Company the lump-sum periodic payment. Upon receiving Client's periodic payment, Leasing Company pays both Driver's wages and M&IE reimbursement. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver as a reimbursement of Driver's M&IE. Leasing Company also accounts to Client by referring to the substantiation Client had received from Driver and had submitted (via a copy) to Leasing Company. Client accepts the substantiation submitted by Leasing Company and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement with Leasing Company and is subject to the § 274(n) limitation.

LAW

Section 162(a)(2) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (such as M&IE) while away from home in the pursuit of a trade or business.

In general, § 274(d)(1) provides that no deduction is allowed under § 162 to a taxpayer for traveling expenses (including M&IE) unless the taxpayer substantiates the

expenses. If the taxpayer is an employee and is reimbursed for M&IE by a payor (whether the employer, the employer's agent, or a third party), the employee satisfies § 274(d) by accounting to the payor with adequate records substantiating the amount of the expense, the time and place of the expense, and the business purpose of the expense. Section 1.274-5(f)(4)(i) (last sentence) and (f)(4)(iii) of the Income Tax Regulations. With some exceptions, an employee who adequately accounts for the M&IE is not again required to substantiate the expenses. Section 1.274-5T(f)(5) of the temporary Income Tax Regulations. If the payor and employee use the annually updated revenue procedure to substantiate the expenses, the M&IE amount (to the extent reimbursed and substantiated) is treated as an expense for food or beverages and is subject to § 274(n). See section 6.05 of Rev. Proc. 2007-63. If the taxpayer is an independent contractor and receives a payment for M&IE under a reimbursement or other expense allowance arrangement from a client, § 274(d) requires that the independent contractor account to the client with adequate records, or other sufficient evidence corroborating the independent contractor's own statement, substantiating the amount of the expense, the time and place of the expense, and the business purpose of the expense. Section 1.274-5T(h)(3). Unlike an employee, however, an independent contractor must maintain a copy of the records, or other sufficient evidence, to substantiate the expenses. Section 274(d); § 1.274-5T(h)(2).

Section 274(n)(1) generally limits the amount allowed as a deduction for any expense for food or beverages to 50 percent of the expense, although § 274(n)(3) generally imposes a lesser limitation on deductions for truck drivers' expenses.

However, § 274(n)(2) excepts expenses described in § 274(e)(3) from the limitation imposed by § 274(n)(1).

Section 274(e)(3) expenses are those paid or incurred by a taxpayer in connection with the performance of services for another person (whether or not that other person is the taxpayer's employer) under a reimbursement or other expense allowance arrangement with that other person. If the payment is made to an employee, the § 274(e)(3)(A) exception applies to the employee only to the extent the employer does not report the payment as compensation to the employee on the employer's originally filed income tax return and as wages to the employee for purposes of withholding under Chapter 24. Section 1.274-2(f)(2)(iv)(b). If the payment is made to an independent contractor, the § 274(e)(3)(B) exception applies to the independent contractor to the extent the independent contractor accounts for the expenses to the payor in a manner satisfying § 274(d). Section 1.274-2(f)(2)(iv)(c).

For purposes of § 274(e)(3), a "reimbursement or other expense allowance arrangement" includes, but is not limited to, an "accountable plan" as that term is defined for purposes of § 62(c). See § 1.62-2(c)(1). Since 1963, § 1.274-2(f)(2)(iv)(a) has provided that the term "reimbursement or other expense allowance arrangement" in § 274(e)(3) has the same meaning it has "in section 62(2)(A), but without regard to whether the taxpayer is the employee of a person for whom services are performed." T.D. 6658, 1963-2 C.B. 113. The subsequent addition of § 62(c) in 1988 and its accompanying regulations did not change the meaning of "reimbursement or other expense allowance arrangement" for purposes of § 274(e)(3). Thus, the application of

§ 274(e)(3) does not require the existence of an accountable plan within the meaning of § 62(c) and the regulations under that section.

Section 274(n)(1) limits certain deductions allowable under § 162. If an employee or independent contractor incurs M&IE in connection with the performance of services for another person and is not reimbursed, § 274(n) limits any § 162(a)(2) deduction claimed by the employee or independent contractor. If an employee accounts for the expenses under § 274(d) to the payor, is reimbursed under a reimbursement or other expense allowance arrangement, and the payment is not treated both as additional compensation and as wages for income tax withholding purposes, then under § 274(e)(3)(A), the employee is not subject to § 274(n). See § 274(n)(2)(A) and § 1.274-2(f)(2)(iv)(a). The party initially making the reimbursement (“initial payor”) bears the expenses, and § 274(n) limits that party’s § 162(a)(2) deduction, unless that party also satisfies § 274(e)(3)(B). Sections 1.274-2(f)(2)(iv)(b) and 1.274-5(f)(4)(iii). If the initial payor, in connection with its performance of services for a third party, is reimbursed under a reimbursement or other expense allowance arrangement with the third party, and the initial payor accounts to the third party in the same manner that the employee accounted for the expenses to the initial payor, then the initial payor satisfies § 274(e)(3)(B). Section 1.274-2(f)(2)(iv)(c)(1). In that case, the third party bears the expenses, and § 274(n) limits the § 162(a)(2) deduction that the third party claims for those expenses.

In Transport Labor Contract/Leasing, Inc. v. Commissioner, 461 F.3d 1030 (8th Cir. 2006), rev’g 123 T.C. 154 (2004) (TLC), the question was the application of § 274(n) for taxable years ending in 1993 through 1996 to an employee leasing

arrangement that provided for the payment to employees of per diem allowances for M&IE. The Court of Appeals for the Eighth Circuit found that the trucking company clients, not the leasing company (TLC), actually bore the per diem expenses under the reimbursement arrangement between the parties. The appellate court held that TLC qualified for the exception in § 274(e)(3)(B) and, therefore, that TLC's § 162(a)(2) deduction for the per diem expenses was not limited by § 274(n).

The appellate court reversed the Tax Court, which had held that § 274(n) limited TLC's § 162(a)(2) deduction because TLC was the drivers' common law employer. Under the Tax Court's analysis, the § 274(n) limitation necessarily applies to the employees' common law employer. Compare Beech Trucking Co. v. Commissioner, 118 T.C. 428, 443 (2002) (relying on common law employer factor and identity of party ultimately bearing the expense to determine incidence of § 274(n) limitation). The appellate court opined that the Tax Court had erroneously failed to examine whether TLC qualified for the exception in § 274(e)(3)(B).

In TLC, the Court of Appeals for the Eighth Circuit determined that TLC's § 162 deduction ultimately was not limited by § 274(n) because TLC was not the party that ultimately bore the per diem expenses. The appellate court concluded that status as a common law employer is not dispositive in the § 274(n) analysis, but did not explicitly reject that status as a relevant factor. The Internal Revenue Service acquiesces in the result in TLC and agrees with the appellate court's opinion that the § 274(n) limitation should apply to the party that ultimately bears the per diem expenses. However, the Internal Revenue Service does not agree with the opinion to the extent that it could be read to imply that status as a common law employer is relevant to the § 274(n) analysis.

ANALYSIS

In each situation below, Driver is an employee who incurs M&IE in connection with the performance of services for another person, receives a reimbursement at the M&IE rate, and accounts for the reimbursement under a “reimbursement or other expense allowance arrangement” within the meaning of § 274(e)(3). Neither Leasing Company nor Client deducts the M&IE amounts as compensation paid to Driver on its originally filed income tax return, nor treats the M&IE amounts as wages paid to Driver for purposes of withholding under Chapter 24. Therefore, under § 274(e)(3)(A), Driver is not subject to § 274(n).

Situation 1. Leasing Company, as payor of the substantiated M&IE reimbursement to Driver, must determine if its deduction of the expenses under § 162(a) is subject to the § 274(n) limitation. Although Leasing Company pays the M&IE of each driver in connection with its performance of services for Client, Leasing Company has provided Client only an invoice for a lump-sum periodic payment due. Therefore, Leasing Company does not satisfy § 274(e)(3)(B) because it has not accounted to Client in a manner satisfying § 274(d) and does not have a reimbursement or other expense allowance arrangement with Client. Under these circumstances, Leasing Company bears the expense of the M&IE, and § 274(n) limits Leasing Company’s § 162(a)(2) deduction for the M&IE, regardless of whether Leasing Company or Client is Driver’s employer under the usual common law rules. Even if Leasing Company had provided an itemized invoice to Client designating a portion of the periodic payment as a reimbursement of Driver’s M&IE, Leasing Company still does not satisfy § 274(e)(3)(B) because it has not accounted to Client in a manner satisfying

§ 274(d) and does not have a reimbursement or other expense allowance arrangement with Client.

Situation 2. Leasing Company, as payor of the substantiated M&IE reimbursement to Driver, must determine if its deduction of the expenses under § 162(a) is subject to the § 274(n) limitation. Leasing Company has the information Driver originally submitted to account for Driver's M&IE. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver that was a reimbursement of Driver's M&IE. Leasing Company also accounts to Client by delivering to Client a copy of the substantiation that Driver had originally provided to Leasing Company. Client accepts the substantiation submitted by Leasing Company and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement and is subject to the § 274(n) limitation. Leasing Company meets the requirements of § 274(e)(3)(B) because (1) under the employee leasing contract and as indicated by their course of dealing, Leasing Company can prove that it has established a reimbursement or other expense allowance arrangement with Client within the meaning of § 274(e)(3), and (2) Leasing Company accounts to Client by delivering a copy of the substantiation that Driver had provided to Leasing Company (i.e., in a manner satisfying § 274(d)). Therefore, Leasing Company is not subject to § 274(n), Client bears the expense of the M&IE, and § 274(n) limits Client's § 162(a)(2) deduction for the M&IE, regardless of whether Leasing Company or Client is Driver's employer under the usual common law rules.

Situation 3. Leasing Company has a copy of the information Driver originally submitted to Client to account for Driver's M&IE. Leasing Company, as payor of the substantiated M&IE reimbursement to Driver, must determine if its deduction of the expenses under § 162(a) is subject to the § 274(n) limitation. Immediately after Leasing Company pays Driver, Leasing Company sends Client a statement indicating the amount paid to Driver that was a reimbursement of Driver's M&IE. Leasing Company also accounts to Client by referring to the substantiation Client had received from Driver and had submitted (via a copy) to Leasing Company. Client accepts the substantiation submitted by Leasing Company, and acknowledges that the portion of its periodic payment equal to the amount that Leasing Company paid to reimburse Driver's M&IE is paid under a reimbursement arrangement and is subject to the § 274(n) limitation. Leasing Company meets the requirements of § 274(e)(3)(B) because (1) under the employee leasing contract and as indicated by their course of dealing, Leasing Company can prove that it has established a reimbursement or other expense allowance arrangement with Client within the meaning of § 274(e)(3), and (2) Leasing Company accounts to Client by referring to the substantiation that Driver originally submitted to Client (i.e., in a manner satisfying § 274(d)). Therefore, Leasing Company is not subject to § 274(n), Client bears the expense of the M&IE, and § 274(n) limits Client's § 162(a)(2) deduction for the M&IE, regardless of whether Leasing Company or Client is Driver's employer under the usual common law rules.

HOLDINGS

(1) In Situation 1, Leasing Company's deduction for reimbursement of the M&IE to Driver is subject to the § 274(n) limitation.

(2) In Situation 2, Client's deduction for reimbursement of the M&IE to Leasing Company is subject to the § 274(n) limitation.

(3) In Situation 3, Client's deduction for reimbursement of the M&IE to Leasing Company is subject to the § 274(n) limitation.

DRAFTING INFORMATION

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