Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-390-00
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date: FEB 29 2000

to: Examination Division, Southern California District
ATTN: Roger Barber, Revenue Agent, CE:1112

from: Associate District Counsel, Southern California District, San Diego

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subject: [redacted] - **De Minimis Fringe Benefits - Meals**

This memorandum responds to your request for advice regarding the application of I.R.C. § 274(n) to certain meal expenses incurred by [redacted] (the "Taxpayer") during the fiscal years ending [redacted], [redacted] and [redacted] and the Taxpayer's treatment of certain meal expenses as "de minimis fringe benefits" within the meaning of I.R.C. § 132(e).

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ISSUES

1. Whether the limitation under I.R.C. § 274(n) applies to expenses incurred by the Taxpayer, in connection with the performance of services for the United States Government, under cost-reimbursement contracts.

2. Whether the payment of cash by the Taxpayer to its employees as reimbursement for business meals qualifies as a "de minimis fringe benefit" within the meaning of I.R.C. § 132(e).

3. Whether the provision of in-kind meals provided by the Taxpayer to its employees qualifies as a "de minimis fringe benefit" within the meaning of I.R.C. § 132(e).

4. Whether the Service should agree to sample [redacted] for the taxable year ending [redacted] (as proposed by the Taxpayer) for determining the amount of expenses that were mistakenly limited by I.R.C. § 274(n) in the years at issue.

CONCLUSIONS

1. There is no per se rule on this issue. The Service must evaluate whether the Government cost-reimbursement contracts are "reimbursement or other expense allowance arrangement" as defined in Treasury Regulation § 1.62-2. In addition, the Taxpayer must establish that it "accounted" to the Government for the travel and entertainment expenses with adequate records to comply with I.R.C. § 274(d).

2. At this stage, we do not have sufficient information to reach a conclusion on this issue. As a general rule, a cash benefit provided by the Taxpayer can never qualify as a "de minimis fringe benefit." There is one exception to this rule, however, for meals, meal allowances, and local transportation fare provided to an employee occasionally to enable that employee to work overtime. The Taxpayer has not provided any documents or information establishing that the cash reimbursements made by the Taxpayer to its employees for business meals meet the requirements of the exception.

3. At this stage, we do not have sufficient information to reach a conclusion on this issue. The Taxpayer has not provided any documents or information establishing the value of the in-kind meals provided by it to its employees or the frequency with which it provided the in-kind meals to its employees.

4. No, the Service should not accept the sampling method proposed by the Taxpayer.

FACTS

The Taxpayer is a Delaware corporation in the business of providing [redacted] products to various departments and agencies of the United States Government, as well as foreign governments and commercial customers. The Taxpayer files its income tax return using a fiscal year ending January 31.

Cost-Reimbursement Contracts

During the years at issue, the Taxpayer performed its services under different types of contracts, including government and non-government cost-reimbursement contracts. The Taxpayer apparently was allowed to, and did, request reimbursement under the cost-reimbursement contracts for expenses that would constitute entertainment expenses within the meaning of I.R.C. § 274. On its income tax returns, the Taxpayer limited the amount of the deduction for these expenses to 50 percent of the amount incurred pursuant to I.R.C. § 274(n).

The Taxpayer now claims with respect to the government cost-reimbursement contracts that it mistakenly limited the deduction. Citing I.R.C. § 274(n)(2) and I.R.C. § 274(e)(3), the Taxpayer argues that the limitation under I.R.C. § 274(n) does not apply to any expenses that it incurred, in connection with the performance of services for the Government, under a reimbursement arrangement with the Government.

Meals for Employees

The Taxpayer maintains a policy for reimbursing its employees for all business meals, including those taken with co-workers. In order to get reimbursement for a meal, the employee who pays for the meal is required to submit an expense report, the receipt for the meal, and a "business luncheon/dinner report." The business luncheon/dinner report includes the amount of the meal and other reimbursable costs (e.g., parking), the date and location of the meal, the persons present at the meal and their company affiliation, and the nature of the business discussed.

On its income tax returns for the years at issue, the Taxpayer limited the amount of the deduction for all business meals to 50 percent of the amount incurred pursuant to I.R.C. § 274(n). The Taxpayer, however, now claims that it mistakenly

limited the deduction. Citing I.R.C. § 274(n)(2), the Taxpayer argues that the limitation under I.R.C. § 274(n) does not apply to the business meals taken with co-workers, because they qualify as "de minimis fringe benefits" within the meaning of I.R.C. § 132(e). The Service states the Taxpayer's position as follows:

> The Deloitte team argues that any meal provided by an employer to an employee outside the normal workday qualifies as a de minimis meal. This includes breakfast, lunch, or dinner. It is not necessary that the meal be provided to the employee to allow the employee to work paid over-time, but that any meal provided to an employee outside of the normal working hours where business is discussed qualifies as a de minimis meal.

See the Service's Request for Advice, p. 3.

Proposed Sampling Methodology

In light of the above claims, the Taxpayer evaluated the accuracy of the expenses charged to [redacted], the account to which all meals and entertainment expenses are charged, for the taxable year ending [redacted]. The Taxpayer conducted an analysis of [redacted] using a sample of 80 items charged to the account. After a review of this sample, the Taxpayer concluded that 39 percent of the amounts charged to [redacted] were mistakenly included in [redacted] as amounts to which I.R.C. § 274(n) applied. The Taxpayer would like to apply this percentage to the amounts charged to [redacted] for the years at issue and treat 39 percent of the amounts charged as not limited by I.R.C. § 274(n).

The Taxpayer divided its mistakes into three categories: (1) expenses misclassified as meals and entertainment expenses, (2) expenses for recreational and social functions for employees, and (3) de minimis meal expenses of employees. It is our understanding that the Service agrees with the Taxpayer's determinations with respect to most, if not all, of the mistakes in categories (1) and (2), above, but disagrees with the Taxpayer's determinations with respect to category (3), above.

DISCUSSION

I. DEDUCTION FOR MEALS AND ENTERTAINMENT EXPENSES

While I.R.C. § 162 allows a taxpayer to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, I.R.C. § 274 imposes some restrictions on this entitlement. Specifically, a taxpayer is not entitled to deduct any expense paid or incurred with respect to an activity that is considered entertainment,[1] amusement, or recreation, unless he establishes that the expense is directly related to, or associated with, the active conduct of his trade or business. I.R.C. § 274(a). In order to meet this burden, the taxpayer must substantiate with adequate records or other sufficient evidence (1) the amount of the expense, (2) the time and place of the travel, entertainment, amusement, or recreation, (3) the business purpose of the expense, and (4) the business relationship to the taxpayer of persons entertained. I.R.C. § 274(d).

If the taxpayer does establish the relationship between the expense and his business, the taxpayer generally is entitled to deduct only 50 percent of the expense (the "50-Percent Limitation"). I.R.C. § 274(n).[2] The taxpayer, however, may avoid the 50-Percent Limitation if, among others:

1. the taxpayer treats the expense as compensation to an employee on its return;
2. a. the taxpayer pays or incurs the expenses, in connection with the performance of services for another person, under a reimbursement or other expense allowance arrangement and
   b. the taxpayer accounts (to the extent provided in I.R.C. § 274(d)) to such person;

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[1] 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." Treas. Reg. § 1.274-2(b).

[2] For taxable years beginning before January 1, 1994, the taxpayer is entitled to deduct 80 percent of the expense.

3. the taxpayer pays or incurs the expenses for recreational, social, or similar activities primarily for the benefit of employees; or
4. the expense for food or beverages is excludable from gross income by the recipient as a "de minimis fringe" under I.R.C. § 132(e).

I.R.C. § 274(n)(2) and I.R.C. §§ 274(e)(2), (3), and (4).

Cost-Reimbursement Contracts

The 50-Percent Limitation under I.R.C. § 274(n) does not apply to any expense if such expense is "paid or incurred by the taxpayer, in connection with the performance by him of services for another person (whether or not such other person is his employer), under a reimbursement or other expense allowance arrangement" but only if the taxpayer accounts (within the meaning of I.R.C. § 274(d)) to such other person. I.R.C. §§ 274(n)(2) and 274(e)(3); Treas. Reg. § 1.274-2(f)(2)(iv)(c).[3] In such circumstances, the 50-Percent Limitation is applied only once, either to the person who makes the expenditure or to the person who actually bears the expense, but not both. Treas. Reg. § 1.274-2(f)(iv)(a).

The term "reimbursement or other expense allowance arrangement" has the same meaning as it has under I.R.C. § 62(a)(2)(A),[4] without regard to whether the taxpayer is an employee of the person for whom services are performed. Id. Under I.R.C. § 62(a)(2)(A), the term "reimbursement or other expense allowance arrangement" means an arrangement that:

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[3] "[I.R.C. § 274(e)(3)] also will not apply in the case of a practitioner, etc., unless he accounts to the client, etc., for the expenses incurred. . . . Thus, if a lawyer enters into a fee arrangement under which his client agrees to reimburse him for expenses (including entertainment expenses) the exception will not apply unless he accounts to his client sufficiently to enable the client to substantiate the expenses as required by the bill." H.R. Rep. No. 1447, 87th Cong., 2nd Sess., pt. V (1962), 1962-3 C.B. 402, 429.

[4] Treasury Regulation § 1.274-2(f)(iv)(a) refers to I.R.C. § 62(2)(A). In 1986, I.R.C. § 62(2)(A) was redesignated as I.R.C. § 62(a)(2)(A).

1. provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions and that are paid or incurred by the employee in connection with the performance of services as an employee;
2. requires the employee to substantiate each travel, entertainment, or other business expense governed by I.R.C. § 274(d) with sufficient information to satisfy the requirements of I.R.C. § 274(d);
3. requires the employee to substantiate each business expense not governed by I.R.C. § 274(d) with sufficient information to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities; and
4. requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated.

Treas. Reg. §§ 1.62-2(c), (d), (e), and (f).

In this case, the Taxpayer would like to treat its Government cost-reimbursement contracts as reimbursement arrangements within the meaning of I.R.C. § 274(e)(3) and deduct the full amount of the entertainment expenses incurred under these contracts. While some Government cost-reimbursement contracts may qualify as reimbursement arrangements within the meaning of I.R.C. § 274(e)(3), they do not qualify automatically. The taxpayer still must establish that the Government cost-reimbursement contract meets the requirements set forth in Treasury Regulation § 1.62-2. And while some taxpayers performing services under a Government cost-reimbursement contract may argue successfully the application of I.R.C. § 274(e)(3) to their cases, they first must establish that it has "accounted" to the Government for the entertainment expenses.

In this case, it is unclear whether the Taxpayer performs its services under a reimbursement arrangement covered by I.R.C. § 274(e)(3) or otherwise contemplated by that section.[5] In

[5] Arguably, the cost-reimbursement contracts are not the type of reimbursement arrangements contemplated by I.R.C. § 274. Typically, the reimbursement arrangement covers reimbursement of expenses incidental to the performance of services. For example, a corporation hires an engineer to perform certain services for which it pays a fee and also agrees to reimburse the engineer for any travel and entertainment expenses he incurs. In this

particular, do the cost-reimbursement contracts specifically require reimbursement for travel and entertainment expenses? And do the cost-reimbursement contracts specifically require the Taxpayer to substantiate the travel and entertainment expenses with adequate records or other evidence in compliance with I.R.C. § 274(d)? The Taxpayer cannot satisfy this requirement simply by voluntarily submitting the records necessary to comply with I.R.C. § 274(d), especially where the Government does not ask for them or take any action with respect to them. Cf. Treas. Reg. § 1.62-2(c)(3) ("If a payor provides a nonaccountable plan, an employee who receives payments under the plan cannot compel the payor to treat the payments as paid under an accountable plan by voluntarily substantiating the expenses.")

It is also unclear whether the Taxpayer "accounts" for the expenses as required by I.R.C. §§ 274(d) and 274(e)(3). The Taxpayer must submit adequate records or other sufficient evidence to the Government establishing each element of the expense, including the amount of each separate expense, date and location of the entertainment, the nature of the business benefit derived from the entertainment, and the business relationship of the persons entertained. Treas. Reg. § 1.274-5T(h)(3).

We recommend that the Service develop this issue further. Specifically, the Service should review the Taxpayer's contracts to determine whether they meet the requirements of I.R.C. § 1.62-2 and review the records submitted to the Government to determine whether they meet the substantiation requirements of I.R.C. § 274(d). In addition, the Service should obtain the Taxpayer's analysis or arguments on why I.R.C. § 274(e)(3) applies to its case.

Meals for Employees

The 50-Percent Limitation under I.R.C. § 274(n) does not apply to any expense if such expense qualifies as a "de minimis fringe benefit" and, therefore, is excludable from the gross income of the recipient. I.R.C. § 274(n)(2). The term "de minimis fringe" means "any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's

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example, the reimbursement of the travel and entertainment expenses are incidental to the performance of services. In this case, however, the Government reimburses the Taxpayer for all of its costs, all of which are part and parcel of the services.

employees[6]) so small as to make accounting for it unreasonable or administratively impracticable." I.R.C. § 132(e) (emphasis added). Examples of de minimis fringe benefits include occasional typing of personal letters; occasional cocktail parties, group meals, or picnics for employees and their guest, coffee, doughnuts, and soft drinks; and local telephone calls. Treas. Reg. § 1.132-6(e).

In providing guidance on how to determine what constitutes a de minimis fringe benefit, the regulations first draw a distinction between two types of benefits, cash (or cash equivalent) benefits and in-kind benefits. The regulations set more onerous standards for cash benefits than for in-kind benefits.

On the one hand, with one exception, the provision of a cash fringe benefit is never excludable from gross income under I.R.C. § 132(a) as a de minimis fringe benefit. Treas. Reg. § 1.132-6(c). The provision of cash for meals or as a meal allowance is excludable as a de minimis fringe benefit

> if the benefit provided is reasonable and is provided in a manner that satisfies the following three conditions:
>
> (A) *Occasional basis.* The meals, meal money or local transportation fare is provided to the employee on an occasional basis. Whether meal money or local transportation fare is provided to an employee on an occasional basis will depend upon the frequency i.e. the availability of the benefit and regularity with which the benefit is provide by the employer to the employee. Thus, meals, meal money, or local transportation fare or a combination of such benefits provided to an employee on a regular or routine basis is not provided on an occasional basis.
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> (B) *Overtime.* The meals, meal money or local transportation fare is provided to an employee because overtime work necessitates an extension of the employee's normal work schedule. This condition does not fail to be

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[6] For purposes of de minimis fringe benefits, the term "employees" means any recipient of a fringe benefit.

> satisfied merely because the circumstance giving rise to the need for overtime work are reasonably foreseeable.
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> (C) *Meal money.* In the case of a meal or meal money, the meal or meal money is provided to enable the employee to work overtime. Thus, for example, meals provided on the employer's premises that are consumed during the period that the employee works overtime or meal money provided for meals consumed during such period satisfy the condition.
>
> In no event shall meal money or local transportation fare calculated on the basis of the number of hours worked (e.g., $1.00 per hour for each hour over eight hours) be considered a de minimis fringe benefit.

Treas. Reg. § 1.132-6(d)(2). With respect to the provision of a cash benefit, the frequency with which the employer provides the cash benefit to its employees is determined on an employee-by-employee basis. Treas. Reg. § 1.132-6(b)(1). The frequency is never determined by reference to the frequency with which the employer provides the cash benefit to the workforce as a whole. Treas. Reg. § 1.132-6(b)(2).

On the other hand, the provision of in-kind benefits, including in-kind meals, are excludable from gross income under I.R.C. § 132(a) as de minimis fringe benefits, as long as it falls within the definition, i.e., the in-kind benefit is small in value and is provided only occasionally. The frequency with which the employer provides the in-kind benefit to its employees generally is determined on an employee-by-employee basis. Treas. Reg. § 1.132-6(b)(1). But, to the extent that such a determination is administratively difficult, the frequency is determined by reference to the frequency with which the employer provides in-kind benefits to its workforce as a whole. Treas. Reg. § 1.132-6(b)(2).

In this case, the Taxpayer reimburses its employees for their business meals, including meals with clients and co-workers. The Taxpayer claims that the provision of the meals is a de minimis fringe benefit within the meaning of I.R.C. § 132(e).

The Taxpayer's provision of meals to its employees consists of both a cash benefit and in-kind benefit, a cash benefit to the

employee paying, and requesting reimbursement, for the meal and an in-kind benefit for the other employee. Each benefit is analyzed separately for purposes of applying the rules under I.R.C. § 132(e).

As discussed above, the cash reimbursement is not excludable from gross income as a de minimis fringe benefit, unless it meets the requirements of Treasury Regulation § 1.132-6(d)(2) relating to overtime meals. Treas. Reg. § 1.132-6(c). At this stage, the Taxpayer has not presented any documents or information establishing that the cash reimbursements meet any of the requirements. Specifically, it has not provided an analysis of the frequency of the cash reimbursements on an employee-by-employee basis, and it has not established any correlation between the provision of the benefit and overtime.

Before the Service can reach any determination on this issue, it should consider the following questions:

1. What is the Taxpayer's policy for reimbursing its employees for meals?

   The Service should obtain any written policy statements, manuals setting forth the procedures for requesting reimbursement, and other similar materials that address this question.

2. How often does each individual employee receive cash reimbursement for his meals?

   The Taxpayer must conduct an employee-by-employee analysis. And the Service should not agree to any sampling methodology as a resolution to this question.

3. What is the normal work schedule for each employee receiving cash reimbursement?

   The Service should obtain any written policy statements, job descriptions, employment contracts, and other similar materials that may describe the normal work schedule for the Taxpayer's employees. The Service may need to interview the Taxpayer's employees to obtain this information.

4. Does the Taxpayer track each employee's work schedule and his "overtime?" Are there time sheets, sign-in sheets, or other similar records?

If the Taxpayer cannot establish the necessary elements, it is not entitled to treat the cash reimbursements as de minimis fringe benefits for purpose of the 50-Percent Limitation under I.R.C. § 274(n).

An in-kind meal is excludable from gross income as a de minimis fringe benefit if it is small in value and is provided occasionally. While the in-kind meal may meet the requirements of Treasury Regulation § 1.32-6(d)(2), it need not do so. Again, however, the Taxpayer has not presented any documents or information that the in-kind meals qualify as de minimis fringe benefits. The Taxpayer must establish the frequency with which it provides the in-kind meals to its employees and the value of these meals.

We recommend that the Service take the following actions with respect to in-kind meals:

1. obtain from the Taxpayer an analysis of the frequency with which it provides the in-kind meals to its employees.

   The Taxpayer should conduct this analysis on an employee-by-employee basis. The Service should recognize that the Taxpayer may have a valid argument for conducting the analysis on a workforce basis on the grounds that it is administratively difficult to conduct an employee-by-employee analysis. We note, however, that it is not sufficient for the Taxpayer to say that it did not account for the in-kind meals on an individual basis. The Taxpayer must demonstrate why it is administratively difficult to track the benefits.

2. obtain from the Taxpayer the aggregate value of the in-kind meals provided to each employee.

The parties may consider an appropriate sampling methodology to resolve these issues.

II. SAMPLING METHODOLOGY

The Taxpayer claims that it mistakenly treated certain expenses as entertainment expenses subject to I.R.C. § 274(n) for the years at issue. But it has not provided any analysis of [redacted], the account to which entertainment expenses are charged, to show what amounts were improperly limited by I.R.C. § 274(n). The Taxpayer has proposed the following:

1. sample 80 items charged to [redacted] during the year ending [redacted];
2. identify the amounts improperly charged to [redacted] and limited by I.R.C. § 274(n);
3. calculate the percentage of amounts improperly charged to [redacted] to total amount charged to [redacted]; and
4. apply percentage to amounts charged to [redacted] for years at issue.

Under the Taxpayer's analysis, 39 percent of the amounts charged to [redacted] were mistakenly included in [redacted] as amounts to which I.R.C. § 274(n) applied.

We have several objections to the Taxpayer's proposed sampling methodology. First, the Taxpayer has chosen to sample a year outside the scope of the Service's examination. The circumstances that existed in the year ending [redacted] may not be the same as those that existed in the years at issue. Any difference in the circumstances could affect the magnitude of the amounts charged to [redacted] or the magnitude of the mistakes made in classifying the expenses. The Service should consider the following questions:

1. Did the Taxpayer incur substantially more entertainment-type expenses in the year ending [redacted] than in the years at issue?

   If so, why?

2. Did the Taxpayer alter its accounting procedures with respect to entertainment-type expenses after the years at issue?

3. Was the same employee responsible for making the journal entries to [redacted] in the years in issue and the year ending [redacted]? What was the experience level of the employee responsible for making journal entries to [redacted] during the year ending [redacted]?

4. Did the Taxpayer acquire or dispose of subsidiaries or branches/divisions?

Although we do not recommend that the Service use a sample involving the year ending [redacted], we recognize that the Service may find the expenses charged to [redacted] during the year ending [redacted] representative of the

expenses charged to [redacted] during the years at issue and the use of data for the year ending [redacted] to be in the best interests of both parties. We, therefore, recommend that the Service take the necessary precautions to ensure that the amounts charged to [redacted] during the year ending [redacted], are, in fact, representative of the amounts charged to [redacted] during the years at issue.

Second, the Taxpayer has sampled significantly less than one percent of the amounts charged to [redacted].[7] This is not an adequate sample. The Service should follow the procedures in the Internal Revenue Manual or other guidelines for conducting a valid statistical sample.

Third, the Taxpayer has not separated its sample into two groups, one for large expense items and one for small expense items. By doing so, the Taxpayer has skewed the results quite dramatically. For example, if all amounts exceeding $500 are removed from the Taxpayer's sample, the percentage of mischarged expenses drops to 20 percent, nearly half of the percentage calculated by the Taxpayer. We recommend, therefore, that the Service divide the expenses sampled into at least two groups (e.g., expenses under $500 and expenses over $500).

Finally, as discussed above, the Taxpayer must meet several requirements before it can treat the cash reimbursements for meals as de minimis fringe benefits and cannot use the sampling technique with respect to these items. The Service, therefore, should automatically determine that the Taxpayer correctly identified as expenses subject to the 50-Percent Limitation under I.R.C. § 274(n) all of the expenses in the sample that are claimed by the Taxpayer to be de minimis fringe benefits. If the Taxpayer does present information relating to this issue, the Service will address it separately.

If you have any questions, please call me at (619) 557-6014.

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By: _____
GRETCHEN A. KINDEL
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[7] The Taxpayer sampled $[redacted] in expenses out of an estimated $[redacted].