The Impact on Business Aviation of Final Tax Regulations on Meals and Entertainment

March 25, 2021

By John B. Hoover, NBAA Tax Committee Chair

> This NBAA publication is intended to provide members with an introduction to the rules that relate to meals and entertainment deductions. Readers are cautioned that this publication is not intended to provide more than an illustrative introduction to the subject matter. Since this publication is necessarily general in nature, it is no substitute for the advice of legal and tax advisors who can address specific circumstances.

The final income tax regulations on meals and entertainment expense deductions published on Oct. 9, 2020, include provisions that may impact the deductibility of flights on business aircraft. This resource discusses the comments submitted by NBAA on April 13, 2020, regarding the proposed regulations and several tax issues for business aviation arising under these regulations.

Review the final rule Meals and Entertainment Expenses Under Section 274, Oct. 9, 2020. (PDF) (https://nbaa.org/wp-content/uploads/flight-department-administration/tax-issues/federal-taxes/IRS-Final-Rule-Meals-and-Entertainment-20201009.pdf)

Learn more about NBAA's comments on the proposed rule. (https://nbaa.org/flight-department-administration/tax-issues/federal-taxes/nbaa-files-comments-on-proposed-irs-regulations-for-business-meals-and-entertainment/)

Review the proposed rule, published Feb. 26, 2020. (PDF) (https://nbaa.org/wp-content/uploads/flight-department-administration/tax-issues/federal-taxes/IRS-NPRM-Meals-and-Entertainment-20200226.pdf)

The regulations consist of a preamble, Treas. Reg. § 1.274-11 with respect to entertainment expenses, and Treas. Reg. § 1.274-12 with respect to meals expenses. The preamble to the final regulations was amended by Treasury on Dec. 18, 2020. See *Meals and Entertainment Expenses Under Section 274; Correction*, 85 Fed. Reg. 82,355 (Dec. 18, 2020). These final regulations are effective for tax years beginning after Oct. 9, 2020. See Treas. Reg. § 1.274-11(e), -12(d). The final regulations follow proposed regulations on which taxpayers could rely for expenditures paid or incurred after Dec. 31, 2017.

I. Entertainment Expenses (Treas. Reg. § 1.274-11)

Internal Revenue Code § 274(a) generally disallows deductions for entertainment activities. Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), Public Law 115-97, this disallowance did not apply to certain business entertainment that met the "directly related" or "associated with" business exceptions in § 274(a)(1)(A). Treas. Reg. § 1.274-2(b) defined the term "entertainment," and subsections (c) and (d) of that regulation provided guidance regarding the "directly related" and "associated with" business exceptions.

The final regulations in Treas. Reg. § 1.274-11 reflect amendments under the TCJA that deleted the exception from the entertainment expense disallowance for certain business entertainment activities that met the "directly related" or "associated with" business tests for expenses paid or incurred after Dec. 31, 2017. See P.L. 115-97, §

13,304(a)(1), amended § 274(a)(1)(A). NBAA previously provided comments to the IRS and Treasury regarding this amendment in a request for regulatory guidance on June 13, 2018.

Treasury has not amended the regulations defining entertainment in Treas. Reg. § 1.274-2(b), (c), or (d) to reflect the TCJA. Instead, Treasury issued Treas. Reg. §1.274-11, which restates the definition of "entertainment" from Treas. Reg. § 1.274-2(b), but without the "directly related" or "associated with" business exceptions.

The following are issues arising under the final entertainment regulations that potentially impact business aircraft.

A. Meals Are Not Entertainment

IRS Notice 2018-76 (https://nbaa.org/wp-content/uploads/2018/11/IRS-Notice-re-Business-Meals.pdf) (and subsequently the final regulations) provides that business meals are deductible business expenses (subject to the deduction limitation in § 274(n)), if certain requirements under § 274(k) are met, including the requirement that the taxpayer or its employee be present at the meal and that the meal be provided to such employee or a business associate. See Treas. Reg. § 1.274-12(a)(1). This guidance in Notice 2018-76 appeared to implicitly resolve the concern of whether a business meal might be regarded as an entertainment activity subject to the entertainment disallowance under § 274(a).

NBAA provided comments regarding Notice 2018-76 to the IRS and Treasury on Nov. 5, 2018, requesting confirmation that a meal is not an entertainment activity. To clarify that meeting with a business associate over a meal does not constitute an entertainment activity subject to the entertainment disallowance, the final regulations provide the following:

> [T]he term entertainment does not include food or beverages, unless the food or beverages are provided at or during an entertainment activity. See Treas. Reg. § 1.274-11(b)(1)(ii).

In other words, the act of eating a meal is not an entertainment activity. However, the regulation then explains that the cost of food or beverages for an event that is otherwise an entertainment activity will be treated as part of the entertainment cost subject to disallowance, if the food or beverage expense is not stated separately from the rest of the costs. The important consequence for business aviation is that the cost of a flight to meet with a business associate over a meal will not be treated as an entertainment trip simply because a meal was consumed at the meeting.

In its comments on the proposed regulations, NBAA noted this conclusion for business meals and pointed out that treating a meal in a personal setting as a personal nonentertainment activity would be consistent with the definition of entertainment, which contrasts activities "generally considered to constitute entertainment, amusement, or recreation" with "routine personal" activities. This definition of entertainment appears in both the original and restated definition of entertainment in Treas. Reg. § 1.274-2(b)(1) and § 1.274-11(b)(1). Accordingly, NBAA requested confirmation from Treasury that the principle that eating a meal is not an entertainment activity should apply equally to personal meals. The result would be that travel to a personal meal would be treated as personal nonentertainment travel.

Treasury declined to provide guidance on this issue, stating that this requested guidance relates to the entertainment classification of air travel, which is covered in Treas. Reg. § 1.274-10. See Preamble § 1.B, 85 Fed. Reg. 64,028 (right column). However, this deferral to Treas. Reg. § 1.274-10 for guidance on this issue seems misplaced, since Treas. Reg. § 1.274-10(b)(1) refers back to Treas. Reg. § 1.274-2(b)(1) for the definition of entertainment.

As that regulation notes, "[e]ntertainment does not include personal travel that is not for entertainment purposes." See Treas. Reg. § 1.274-10(b)(1). Therefore, it would seem reasonable to conclude that attending a personal meal with no other entertainment activity would be a personal nonentertainment activity.

B. Trips with Multiple Activities

Consistent with the repeal of the business entertainment exception, the final regulations characterize taking a business associate to "a baseball game to discuss a proposed business deal" or "to a basketball game" as examples of a nondeductible entertainment activity. See Treas. Reg. § 1.274-11(d)(1), (3). The regulations do not discuss the entertainment or nonentertainment classification of travel expenses for trips on which the passenger engaged in both entertainment and nonentertainment activities. For example, if an employee of the taxpayer travels to meet with a business associate in a business meeting during the day and they attend a baseball game in the evening, then the travel costs would seem to be business expenses rather than entertainment expenses if the primary purpose of the trip is to attend the business meeting. This approach would be consistent with the "principal character or aspect" test provided under the now obsolete regulation under the "directly related" test to classify as either business or entertainment an activity that has both business and entertainment character or aspects. See Treas. Reg. § 1.274-2(c)(3)(iii).

The final regulations also do not provide guidance regarding activities that take place in a "clear business setting" as that term was used in the now obsolete regulations under the "directly related" test. See Treas. Reg. § 1.274-2(c)(4). Under those regulations, expenditures for example on a "hospitality room" at a trade show would not be disallowed as entertainment because "the taxpayer had no significant motive… other than directly furthering his trade or business" and "there was no meaningful personal or social relationship" between the parties. This analysis suggests that the hospitality room should be viewed as a place for business networking and not as an activity generally considered to constitute entertainment, amusement, or recreation. More generally, it suggests that events in a clear business setting should not be classified as entertainment activities.

NBAA raised these issues in its request for regulatory guidance on June 13, 2018. The absence of regulatory guidance on these issues in the final regulations leaves them open to future interpretation.

II. Meals Expenses (Treas. Reg. § 1.274-12)

As explained in Section I, A. Meals Are Not Entertainment above, the final regulations "substantially incorporate" guidance regarding the deductibility of employer-provided meals issued by the IRS in Notice 2018-76. See Preamble § 2.A, 85 Fed. Reg. 64,028 (right column). This Notice provided guidance regarding the prohibition on deducting lavish meals in § 274(k) and the 50% meals deduction disallowance in § 274(n). Notice 2018-76, and subsequently the final regulations, explained the requirements that must be met to deduct business meals, including the requirement that the taxpayer (or its employee) attend the business meal and that the meal be served to the taxpayer (or its employee) or a business associate. See Treas. Reg. § 1.274-12(a)(1).

The following discusses several other aspects of these regulations with potential effects on business aircraft.

A. Spouse Travel

The final regulations, like the proposed regulations, explain that the cost of meals is subject to the spouse travel limitations under § 274(m)(3). See Treas. Reg. § 1.274-12(a)(4)(i), (iii). The regulations then provide an example explaining that if a sole proprietor brings his or her spouse on a business trip, and the spouse is not traveling for business, the cost of the spouse's meals on the trip are not deductible. See Treas. Reg. § 1.274-12(a)(4)(iii)(D).

The above guidance regarding the spouse travel rules seems straightforward, and it would seem to apply to other travel costs of a spouse traveling for nonbusiness purposes. In the case of business aircraft, there are two additional considerations that may be relevant. First, the IRS has consistently made it clear in its publication on travel costs that this spouse travel cost disallowance rule only applies to the marginal costs of a spouse's travel. See IRS Pub. 463, at 5. In the case of a business aircraft, the marginal costs of a spouse's flight may be negligible. Second, if certain income and payroll tax reporting requirements are met, the regulations indicate that a company can deduct the costs of providing spouse travel as compensation to an employee or independent contractor. See Treas. Reg. § 1.274-2(f)(2)(iii).

B. 50% Deduction Disallowance for Meals Under § 274(n)

Section 274(n) generally disallows 50% of the expense for meals. However, this disallowance was repealed for 2021 and 2022. See § 274(n)(2)(D). Accordingly, this discussion of § 274(n) is only relevant after 2022.

Section 274(n) was amended in the TCJA to delete the 50% disallowance with respect to business entertainment, because the deduction for business entertainment was repealed by the TCJA. See P.L. 115-97, § 13,304(a)(2)(D); § 274(a)(1)(A). Section 274(n), as amended by TCJA, still generally applies to meals (subject to the temporary suspension for 2021 and 2022). This raised the question of whether the cost of a flight on a business aircraft to have a business meal would be considered a part of the cost of the meal and therefore would be subject to the 50% disallowance.

NBAA requested confirmation that travel costs to a business meal are not subject to the 50% deduction disallowance under § 274(n) consistent with the legislative history of that provision which states "an otherwise allowable deduction for the cost of transportation to and from a business meal (e.g., cab fare to a restaurant) is not reduced pursuant to the rule." See *General Explanation of the Tax Reform Act of 1986*, at 64 (J. Comm. Print 1986).

In response, the preamble to the final regulations makes it clear that "[i]ndirect expenses, including the cost of transportation to a meal, are not included in the definition [of food and beverage expenses under Treas. Reg. § 1.274-12(b)(2)]." See Preamble, § 2, D, 85 Fed. Reg. 64,030 (right column). Accordingly, the 50% deduction disallowance for meals, once it is restored in 2023, should not include the cost of a flight on a business aircraft to and from the meal.

C. Potential Effect of Errors in Calculating Imputed Income on the Compensation Exceptions

The proposed regulations imposed a harsh penalty on taxpayers who made errors in calculating the amount of imputed income with respect to a meal, or even had no requirement to report imputed income. Under the proposed regulation, if the cost of food or beverages was required to be reported as imputed income to an employee or independent contractor, and the taxpayer properly reported the food or beverages as income for income tax and payroll tax purposes, then the employer could deduct the cost of the food or beverages. See Prop. Treas. Reg. § 1.274-12(c)(1), (2). However, the proposed regulations provided that this exception was not available if the employer underreported the amount of the compensation or if there was zero compensation to report (even if the zero amount of compensation resulted from a reimbursement to the taxpayer). See Prop. Treas. Reg. § 1.274-12(c)(2)(i)(C).

NBAA was concerned that if these penalty-type provisions were included in the regulations with respect to meals, then they might in the future become the rule for flights provided as compensation. For example, these rules applicable to meals might be applied by analogy to the tax accounting rules for business aircraft. However, the preamble explains that "[t]he final regulations do not affect the application of the special rules in § 1.274-10 to expenses related to aircraft used for entertainment." See Preamble § 1, 85 Fed. Reg. 64,028 (left column).

Therefore, NBAA commented that this rule was unduly harsh in the case of taxpayers who make errors in calculating imputed income or who are not required to report any compensation due to reimbursements. See Preamble § 2.E.i, 85 Fed. Reg. 64,031 (middle column).

In response to these comments, this rule is relaxed in the final regulations to provide that in the case of a taxpayer reporting an improper amount of compensation, the deduction is allowed to the extent of the amount reported as compensation. See Treas. Reg. § 1.274-12(c)(2)(i)(D). Similar relief was provided in the final regulations in the case of reimbursed costs of food or beverages. Thus, the risk that these regulations could result in a similarly draconian set of rules in the case of underreporting of compensation income from entertainment flights appears to be averted.

D. Adequate and Full Consideration Exception

Section 274(e)(8) provides an exception to the entertainment disallowance for goods or services sold by the taxpayer in a bona fide transaction for adequate and full consideration. While this statute does not limit who the goods and services can be sold to, the corresponding regulation adds the words "to customers" in its statement of this exception. See Treas. Reg. § 1.274-2(f)(2)(ix). IRS agents sometimes assert in the case of flights on business aircraft that the term "customers" limits the exception to flights provided to members of the general public, rather than flights provided to employees of the company.

The final regulations relating to food and beverages explain that the regulatory requirement that the sale be "to customers" is met by a sale to "anyone, including an employee of the taxpayer." See Treas. Reg. § 1.274-12(c)(2)(v). This conclusion that the regulatory reference to "customer" includes anyone including employees is consistent with the statute which does not include any requirement that the sale be to a customer. See § 274(e)(8).

NBAA requested that the regulations clarify that the term "customers" includes anyone including employees of the taxpayer for purposes of § 274(e)(8) generally, not just for purposes of the food and beverages disallowance rules. While the final regulations decline to discuss the application of this definition of "customers" outside the context of food and beverages, the clarification that "customer" includes "anyone" indicates that flights provided to owners or employees are eligible for the exception in § 274(e)(8).

NBAA acknowledges Tax Committee Chair John Hoover for his significant efforts in drafting this resource and assisting with the association's advocacy efforts before the Department of the Treasury and IRS. Hoover is a partner at Holland & Knight, where his aviation practice includes structuring business aircraft arrangements, federal and state tax controversy work, and aircraft transactions.

Sponsor of 

(https://noplanenogain.org/)

Member of 

International Business Aviation Council Ltd. (http://www.ibac.org/)