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Wining and Dining Has Its Limitations

By Steve Minson, CPA

The IRS recently issued a ruling where it clarified which party is entitled to the full deduction for meals and entertainment when the expense is invoiced by a service business ("taxpayer") to its client.

In general, the IRS allows taxpayers to deduct only 50% of certain meals and entertainment (M&E) expenses, such as business related meals incurred by its employees while traveling away from home overnight on business. One specific exception to the general rule applies where a taxpayer negotiates an arrangement with its client to be reimbursed for travel costs (including meals and entertainment) incurred by the employees of the taxpayer in the performance of a contract between the parties. These expenses were separately stated by the taxpayer on its invoice to its client. As a result, the taxpayer is allowed a 100% deduction for the meals and entertainment expense and the 50% limitation is passed onto the client.

While the ruling specifically dealt with an employee leasing situation, it clarifies the position of the IRS as to arrangements where expenses incurred by one party are passed on to another party. Therefore, any business involved in a similar type arrangement should take note of this ruling, as the substantiation requirements discussed are significant.

The rule requires the taxpayer to provide its client with an invoice that separately states the amount that was reimbursed for the expenses of its employee. When the invoice is issued, the taxpayer must also include a copy of the substantiation its employee provided when seeking reimbursement from the taxpayer. In the initial agreement, both parties must acknowledge that the client accepts the substantiation and that its payment is made under a reimbursement arrangement and is subject to the 50% limitation.

It's evident from this ruling that care needs to be exercised by all taxpayers with respect to billing matters and substantiation when seeking reimbursement from clients. Therefore, it is extremely important that your company review its policies and procedures.