



* Meals & Entertainment Rules

Or How to Avoid Inviting Government Auditors to Your Lunch

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- * Issue
- * IRS
- * Government Contracting
- * Accounting Issues

* Agenda

- * Rules on Meal and Entertainment (M&E) expenses while on travel are fairly well documented within the regulations.
- * Unfortunately, the regulations for M&E when not on travel are not as clear and are often applied inconsistently by government auditors
- * In both areas (travel and non-travel) contractors often must make decisions on a case by case basis.
- * Also, there are two government audiences involved:
 - * DCAA
 - * IRS

* Issue

*We will briefly look at the requirements from the IRS and then focus on the government contracting issues

*Issue

*In the majority of cases it is impossible for an outsider (auditor) to separate the social aspect of a meal from the business aspect.

*This led to the 50% rule - an arbitrary division of M&E costs between business (deductible) and social (not deductible).

*IRS

*As a general rule, M&E expenses are deductible when related to the entity trade or business.

*They must be related - anything that could be viewed as purely social should not be considered for deduction (taking the kids to Disney).

*IRS

- * Other exceptions (full deduction):
 - * Compensation
 - * Pass through
 - * For the benefits of employees (Christmas Party)
 - * Give aways
 - * In the course of business (restaurant)
- * Other exceptions (no deduction)
 - * Personal
 - * Excessive



Table 2-1. When Are Entertainment Expenses Deductible?

| | |
|------------------------|---|
| General rule | You can deduct ordinary and necessary expenses to entertain a client, customer, or employee if the expenses meet the directly-related test or the associated test. |
| Definitions | <ul style="list-style-type: none"> • Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation, and includes meals provided to a customer or client. • An ordinary expense is one that is common and accepted in your trade or business. • A necessary expense is one that is helpful and appropriate. |
| Tests to be met | <p>Directly-related test</p> <ul style="list-style-type: none"> • Entertainment took place in a clear business setting, or • Main purpose of entertainment was the active conduct of business, and • You did engage in business with the person during the entertainment period, and • You had more than a general expectation of getting income or some other specific business benefit. <p>Associated test</p> <ul style="list-style-type: none"> • Entertainment is associated with your trade or business, and • Entertainment is directly before or after a substantial business discussion. |
| Other rules | <ul style="list-style-type: none"> • You cannot deduct the cost of your meal as an entertainment expense if you are claiming the meal as a travel expense. • You cannot deduct expenses that are lavish or extravagant under the circumstances. • You generally can deduct only 50% of your unreimbursed entertainment expenses (see 529.L4104). |



- * Subcontractors and Professional Services.
 - * A true 1099 subcontractor or vendor does not usually have to limit their deduction to 50% if:
 - * They are reimbursed by the prime/client (actual or per diem)
 - * They document the expense with the client.
 - * BUT - The Prime can only deduct in accordance with the 50% rule.



- *The IRS requirements (50%) offer a couple of additional challenges to government contractors to include accounting that we will discuss later.

- *None of this is offered as tax advice and you should consult with your tax advisor.

* IRS

- *As complicated as M&E issues are when dealing with the IRS, they are more complicated when dealing with DCAA.

- *As you may be aware, even with the current crisis surrounding DCAA, the FAR pretty much leaves definition of government contractor accounting standards with DCAA (FAR 42.1)

- *This means we need to look at the actual standards (regulations) and how DCAA interprets those regulations.

* Government Contracting

- *The issue divides into two areas:

- *On travel
- *Not on travel

* Government Contracting

* I am not going to spend a lot of time on travel M&E as that is pretty thoroughly covered by the Joint Travel Regulations (JTR) or the Federal Travel Regulations (FTR) and described in FAR 31.205-46

* Basically, contractors are obligated to follow the per diem limits outlined except where there are "special or unusual situations" (FAR 31.205-46(a)(3)).

* Government Contracting

* Non travel M&E is a bit more complicated:

* There are three main sections of the FAR that cover non-travel M&E:

* 31.205-14 Entertainment costs.

* 31.205-13 Employee morale, health, welfare, food service, and dormitory costs and credits.

* 31.205-43 "Trade, business, technical and professional activity costs".

* Government Contracting

* Over the years, each of these section proved limited in interpretation and application, as they are fairly narrow in construction.

* But the establishing section of the 31 is not:

* Government Contracting

31.201.2 Determining allowability.

(a) A cost is allowable only when the cost complies with all of the following requirements:

- (1) Reasonableness.
- (2) Allocability.
- (3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.
- (4) Terms of the contract.
- (5) Any limitations set forth in this subpart.

***Government Contracting**

31.201.3 Determining reasonableness.

(a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.

(b) What is reasonable depends upon a variety of considerations and circumstances, including—

- (1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;
- (2) Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations;
- (3) The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and
- (4) Any significant deviations from the contractor's established practices.

***Government Contracting**

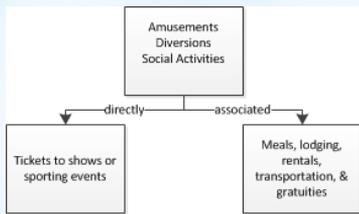
*Given these general and reasonable conditions, let's look at the specific subparts

***Government Contracting**

*** 31.205-14 Entertainment costs.**

* Costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable. Costs made specifically unallowable under this cost principle are not allowable under any other cost principle. Costs of membership in social, dining, or country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees.

*** Government Contracting**



*** Government Contracting**

*** Example:**

* Take a vendor to a football game and the cost of the tickets, parking, hot dogs, and so on cannot be claimed despite the fact that you spent the entire game discussing business and even missed the controversial ref call.

* Take the same vendor to a dinner and the rules get a little foggy.

*** Government Contracting**

- * 31.205-43 "Trade, business, technical and professional activity costs".
- * A quick read of this FAR and one gets the impression it was written to deal with professional activities such as meetings, conventions, conferences, symposiums, or seminars.
- * But both DCAA and the various Contract Appeal Boards expand the scope of this regulation to cover typical non-travel M&E expenses.

* Government Contracting

- * The critical section of the FAR is as follows:
- * Costs are allowable

(c) When the principal purpose of a meeting, convention, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity—

(1) Costs of organizing, setting up, and sponsoring the meetings, conventions, symposia, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs;

* Government Contracting

- * The three requirements then are:
- * Business Information
- * Production Stimulation
- * Or
- * Productivity Improvement
- * The last two seem similar.

* Government Contracting

*An Energy Board of Contract Appeals Decision (*Cotton & Company*, EBCA No. 426-6-89, 90-2 BCA - 22,828 at 114,628) set the standard for non travel meals and was referenced as recently as November 2011 in ASBCA No. 57403 .

*Government Contracting

Before ruling on the reasonableness of these costs, we note that lunch and dinner meetings to discuss business matters are not readily identifiable as performance related or necessary business expenses, since a company can operate without these costs. Because we view them as purely discretionary in nature, and subject to contractor abuse, we hold the contractor to a higher burden in justifying such expenditures. Here, the amounts involved were modest and the frequencies low. There simply is no hint of abuse.

*Government Contracting

(*Cotton & Company*, EBCA No. 426-6-89, p5)

**Cotton* specifically allowed the following type of non travel meetings/events:

- * Lunch to discuss employee performance
- * Lunch to discuss promotions
- * Lunch to discuss company business
- * Friday afternoon get-togethers

*Government Contracting

* Highlights

- * " ...we find that taking an employee out to lunch in a relaxed setting, free from interference, to discuss his future with the company may be for the purpose of stimulating production or improved productivity under FAR 31.204-43(c).
- * Respondent does not challenge the credibility of Appellant's affiants. Rather, it argues that the cost should be disallowed because there was no reason the meeting could not have taken place in the office at a different time and that a restaurant is not a conducive atmosphere for business discussions (Respondent's Brief at 14). As such, Respondent contends that the principal purpose of these meetings was entertainment, not to disseminate technical, business, trade, or professional information or stimulate production (Respondent's Reply to Appellant's Brief at 4).
- We do not find Respondent's arguments convincing. Dissemination of business information can take place at lunch time, in a restaurant.

* Government Contracting

* 31.205-13 Employee morale, health, welfare, food service, and dormitory costs and credits.

- * (a) Aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) are allowable, subject to the limitations contained in this subsection. Some examples of allowable activities are—
 - * (1) House publications;
 - * (2) Health clinics;
 - * (3) Wellness/fitness centers;
 - * (4) Employee counseling services; and
 - * (5) Food and dormitory services for the contractor's employees at or near the contractor's facilities.

* Government Contracting

* Here is what Cotton said about the Friday get-togethers:

- * "It is the opinion of this Board that the afternoon gettogethers are important for employee morale, and that, in the absence of abuse of this practice, these gettogethers are allowable."

* Government Contracting

*But - it can go the other way.

*Government Contracting

* Here is a recent ASBCA decision where the contractor failed to meet the documentation standard(ASBCA No. 57403)

"However, our concern here is less with receipts to show costs were incurred, which is not disputed, and more with whether the criteria of the cost principle were met. Without the type of information noted above, we cannot say that these meal costs qualify as subsistence costs of "organizing, setting up, and sponsoring" a meeting, as required by the cost principle. Certainly we disagree with the over-broad statement that "any expenses incurred outside of the office in the service of the company" are reimbursable (app. reply br. at 16). General assertions that recruiting was discussed at meal meetings, which is all we have to rely on, do not provide an adequate foundation to show compliance with the criteria of the cost principle. Consequently, we cannot conclude that these meal costs are allowable under FAR 31.205-43."

*Government Contracting

*The Trick

* Complete documentation

* Cost

* Attendees

* Business purpose

* Frequency

* That line between Social (Morale) and Business

* Planned

* Occasional Spontaneity

*Government Contracting

- *There are the following accounting issues contractors must address
 - *IRS - Applicable 50% to include subcontractors and consultants (1099s)
 - *DCAA - Direct/Indirect
Claimed/Unclaimed

*Accounting Issues

- *Possible Methods
 - * Chart of Accounts
 - * Tracking Ids/Classes

*Accounting Issues

- * Chart of Accounts
 - * Indirect Costs
 - * Utilize a separate account number for claimed M&E expenses (8XXXX)
 - * Utilize a second account for unclaimed M&E Expenses (9XXXX)
 - * Direct Costs
 - * Create a separate account or subaccount under direct travel and subcontractors to track M&E
 - * Remember unclaimed direct expenses must be burdened with associated indirect costs
- * Tracking
 - * Tracking ids or classes can be used in combination with direct cost account numbers.

*Accounting Issues