



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: JERRY E. HOLMES
CHIEF, EMPLOYMENT TAX BRANCH 2
CC:TEGE:EOEG:ET2

SUBJECT: ASSISTANCE REQUEST WTA-N-129989-01

This Chief Counsel Advice responds to your memoranda dated May 31, 2001, and June 14, 2001. In accordance with Internal Revenue Code (the Code) section 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Company =

ISSUES

Whether expenses in tax years 1996 and 1997 are fully deductible as de minimis fringe benefits.

CONCLUSIONS

Expenses in tax years 1996 and 1997 are not fully deductible as de minimis fringe benefits.

FACTS

The Company is a manufacturer with a large sales force. The Company employs approximately workers. The Company is involved in numerous projects with its parent and subsidiaries of its parent. Many meetings occur between the Company and the parent, the subsidiaries, clients and customers.

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In the conduct of its business, the Company incurs various expenses for meals and entertainment. Tickets to sporting events are purchased and given to employees and customers. The Company is a sponsor of some sporting events. Customers and employees are taken out to restaurants for meals. Coffee, doughnuts, lunches and dinners are purchased for business meetings for employees and customers both on and off of the Company's premises.

The Company maintains various numbered accounts for these types of expenses and other expenses such as advertising, promotions and travel. Expenses in these accounts are considered either 100 percent deductible or 50 percent deductible.

The Company has requested an adjustment of its 1996 and 1997 tax returns. The Company has claimed to identify certain meal and entertainment expenses that were improperly subject to the 50 percent deduction limit in Code section 274(n)(1) for tax years 1996 and 1997. It claims that the expenses should have been fully deductible.

The Company concluded it had erroneously subjected expenses to the Code section 274(n)(1) deduction limit after conducting a statistical sampling of two numbered accounts (the designated accounts). One numbered account is titled "Domestic Travel," and the other numbered account is titled "International Travel." The domestic travel account contained meal and entertainment expenses for employees and clients with respect to domestic travel. The other account contained similar expenses with regard to international travel.

An initial sample of the designated accounts was a nonrandom sample of 3000 Company headquarters items. The Company performed a second statistical sampling of the entire populations of the designated accounts for years 1997 and 1998 using the "dollar value" method of sampling. These samples comprised about 400 items or "dollars" which the Company randomly selected. The results of the second sampling were essentially the same as the results of the initial sampling. The results of the second sample were extrapolated to the entire population¹ of the designated accounts, which is the basis for the refund claim for the 1996 and 1997 tax years at issue. The additional deduction amounts sought for 1996 and 1997 are \$ and \$ respectively.

In an effort to reach a settlement for these tax years, Appeals also conducted a statistical sampling of the designated accounts for year 1996. This sampling consists of 400 items. Your review of the 400 items indicates that 332 of the items were expenses that were reimbursed to the employee by the Company through a reimbursement check or in cash.

¹ The "entire population" refers to all of the dollars in the designated accounts.

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You asked that our office provide answers to several questions. Specifically, you asked whether certain meal and entertainment expenses are properly characterized as de minimis fringe benefits, and you asked that we explain application of Regulation section 1.132-6 with regard to value and frequency of certain expense items. The discussion below addresses these issues.

LAW AND ANALYSIS

INCOME

Section 61 provides that gross income includes all income from whatever source derived, including compensation for services, fees, commissions, fringe benefits, and similar items. A fringe benefit provided in connection with the performance of services will be considered to have been provided as compensation for such services. Regulations section 1.61-21(a)(3).

DEDUCTIONS

Section 162(a) allows a deduction for the ordinary and necessary expenses paid or incurred in carrying on any trade or business. However, a deduction otherwise allowable under section 162(a) may be subject to disallowance or reduction by section 274.

Section 274(n)(1) limits the deduction for any expense for food or beverages to 50 percent of the amount that otherwise would be allowable under section 162(a).

Review of the legislative history that accompanied adoption of the Section 274(n)(1) percent reduction rule reveals that Congress intended to prevent deduction of the personal benefit component inherently associated with employer provided meals and entertainment.

Specifically, Congress believed that prior law, by not focusing sufficiently on the personal-consumption element of deductible meal and entertainment expenses, unfairly permitted taxpayers who could arrange business settings for personal consumption to receive, in effect, a federal tax subsidy for such consumption that was not available to other taxpayers. The taxpayers who benefitted from deductibility tended to have relatively high incomes, and in some cases the consumption was only a loose relationship to business necessity. For example, when executives have dinner at an expensive restaurant following a business discussion and then deduct the cost of the meal, the fact that there may be some bona fide business connection does not alter the imbalance between the treatment of those persons, who have effectively transferred a portion of the cost of their meal to the federal government, and other individuals, who cannot deduct the cost of their meals. See H. Rep. No. 426, 99th Cong., 1st Sess. 120-21 (1985), 1986-3

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C.B. vol. 2 at 120-21, S. Rep. No. 313 99th Cong., 2d Sess. 68 (1986), 1986-3 C.B. vol. 3 at 68.

In light of these considerations, Congress reduced, originally to 80 percent and after 1994 to 50 percent, the amount of otherwise allowable deductions for business meals, including meals while on a business trip away from home, meals furnished on an employer's premises to its employees, and meal expenses at a business luncheon club or a convention, and business entertainment expenses, including sports and theater tickets and club dues. This percent reduction rule reflects the fact that all meals and entertainment inherently involve an element of personal living expenses, but still allows a limited deduction where such expenses also have an identifiable business relationship. *Id.* Accordingly, Congress clearly intended full deductibility of employer provided food and entertainment expenses to be rather limited.

However, section 274(n)(2) excludes certain expenses from the application of section 274(n)(1), including expenses for food or beverages excludable from the recipient's gross income under section 132 by reason of section 132(e), relating to de minimis fringes.

DE MINIMIS FRINGE BENEFITS

Section 132(a)(4) specifically excludes from gross income the value of a de minimis fringe benefit, as defined in section 132(e).²

Section 132(e) defines a de minimis fringe benefit as any property or service the value of which is (after taking into account the frequency with which similar fringe benefits are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable. Regulation section 1.132-6(a) provides a similar definition.

In order for a benefit to qualify as a de minimis fringe benefit, an employer must demonstrate that accounting for provision of the benefit is administratively impracticable. However, the inability to properly account for employer provided benefits created by an employer's choice of accounting systems is not administrative impracticability. An employer cannot tailor its procedures to be administratively difficult for the purpose of achieving de minimis fringe benefit treatment. See American Airlines v. United States, 40 Fed. Cl. 712, 725 (1998), aff'd 204 F.3d 1103, 1112 (Fed. Cir. 2000).

² Regulation section 1.132-1(b)(4) provides "for the purposes of section 132(a)(4) (relating to de minimis fringe benefits), the term 'employee' means any recipient of a fringe benefit." We apply this definition for the purposes of this advice.

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Regulations section 1.132-6(c) makes clear that accounting for provision of certain types of benefits is never considered administratively impracticable. It provides that, except for special rules that apply to occasional meal money, the provision of any cash fringe benefit is never excludable under section 132(a) as a de minimis fringe benefit. Similarly, except for special rules that apply to occasional meal money and transit passes, a cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable under section 132(a) even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit. For example, the provision of cash to an employee for a theater ticket that would itself be excludable as a de minimis fringe benefit is not excludable as a de minimis fringe benefit.

Section 132(e) requires that, in addition to being administratively impracticable to account for, employer provided benefits must be of little value and infrequently distributed to be properly characterized as de minimis fringe benefits. The smaller in value and less frequently a particular benefit is provided, the more likely that such a benefit is properly characterized as a de minimis fringe benefit.

Section 1.132-6(b)(1) provides that, generally, the frequency with which similar fringe benefits are provided by the employer to the employer's employees is generally determined by reference to the frequency with which the employer provides the fringe benefits to each individual employee rather than to the employer's workforce as a whole ("employee-measured frequency").

However, section 1.132-6(b)(2) provides that, where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which the employer provides similar fringe benefits is determined by reference to the frequency with which the employer provides the fringe benefits to the workforce as a whole ("employer-measured frequency"). Therefore, under this rule, the frequency with which any individual employee receives such a fringe benefit is not relevant and in some circumstances, the de minimis fringe exclusion may apply with respect to a benefit even though a particular employee receives the benefit frequently.

Section 1.132-6(e)(1) provides examples of de minimis fringe benefits that are excludable from an employee's gross income. These include occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine; occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).

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Section 1.132-6(e)(2) provides examples of fringe benefits that are not excludable from an employee's gross income as de minimis. These include season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend.

Administrative Impracticability

The value of employer provided meals and entertainment is generally included in gross income unless a specific exception applies, and the burden is on the taxpayer to demonstrate that such an exception applies. In the case of de minimis fringe benefits, it must be demonstrated that it would be administratively impracticable to account for the value of the benefit provided. Because accounting for the value of a cash payment to an employee is not administratively impracticable, provision of a "cash fringe benefit" is never treated as a de minimis fringe benefit unless special meal money rules apply. Similarly, absent application of special meal money rules, accounting for the benefit provided to a particular employee who receives a reimbursement for meal and entertainment expenses is not administratively difficult. If several employees eat individual meals at a restaurant and one of the employees pays for all of the meals and is reimbursed, the fact that one receipt exists for several meals does not mean under Regulation section 1.132-6(c) that it is administratively impracticable for an employer to account for the value of the benefit provided to each employee. The employer has simply failed to establish a system to account for the benefit provided to each employee. The method chosen by the employer of accounting for benefits provided to employees is not determinative of whether accounting for the value of the benefits is administratively impracticable. See American Airlines, supra ("difficulty caused by the employer's chosen accounting system . . . does not constitute administrative impracticability"). The result is of course the same for the application of Regulation section 1.132-6(c) when, for example, 12 employees attend a catered business meeting and each is served a meal. Accordingly, accounting for the value of individual meals that are purchased and provided to individual employees is not administratively impracticable simply because the employer chooses to account for them collectively. Alternatively, accounting for the value of the benefit received by an employee that attends a staff meeting where two pots of coffee and a box of doughnuts are provided to employees is administratively impracticable.

Certainly it may be difficult to determine which employees received which benefits and the value of the benefits several years after the fact. However, it does not appear from our review of the materials submitted that the Corporation has provided any evidence to establish that it would have been administratively impracticable to properly account for the benefits it provided to its employees at the

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time the benefits were provided. Because the Corporation has failed to establish administrative impracticability, we conclude that the adjustments sought should not be granted.

Frequency

The less frequently a benefit is provided, the more likely the benefit is appropriately characterized as a de minimis fringe benefit. Employee-measured frequency requires establishing the frequency with which the benefit is provided to a particular employee. Regulation section 1.132-6(b)(1) provides the following example to demonstrate employee-measured frequency. If an employer provides a free meal in kind to one employee on a daily basis, but not to any other employee, the value of the meals is not de minimis with respect to that one employee even though with respect to the employer's entire workforce the meals are provided "infrequently." Accordingly, it is necessary to determine how many employer provided meals an employee receives. Therefore, in order to determine frequency, an employer must determine which employees received benefits, and how often they received them.

Nothing in the materials submitted indicates that the Corporation determined the frequency with which benefits were provided to individual employees.

Section 1.132-6(b)(2) provides that, where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which the employer provides similar fringe benefits is determined by reference to the frequency with which the employer provides the fringe benefits to the workforce as a whole ("employer-measured frequency").

The position of the Service has been that when an employer has the information to ascertain that particular benefits were provided to particular employees, the employer must determine frequency using the employee-measured frequency standard. Further, whether the frequency determination is administratively difficult is based on an objective demonstration of difficulty not an unsupported assertion.

The Company cannot assume that a determination of administrative difficulty is dependent on the method of payment and choice of procedures used to account for the benefits. If such an approach were valid, an employer could tailor its procedures to be administratively difficult for purposes of achieving de minimis treatment. See American Airlines, supra.

In this case, the Company has made no demonstration that it would be administratively difficult, within the meaning of Regulation section 1.132-6(b)(2), to determine the number of meals that were provided to individual employees. In fact, the material submitted by Company is silent with regard to administrative difficulty.

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The obvious reason the Company does not address administrative difficulty is because the Company in fact did not determine the number of meals that were provided to each employee. It is also obvious that the sampling method chosen by the Corporation does not establish the number of meals provided to each employee. However, the use of the dollar value method of sampling, or any other method, does not establish that employee-measured frequency is administratively difficult. Whether determining employee-measured frequency is administratively difficult when an employer chooses to use statistical sampling is not at issue. While Regulation section 1.132-6(b) does not determine the exact method an employer must use to establish the number of meals that are provided to an individual employee, it does require the employer to establish the number or establish that to do so would be administratively difficult. The evidence that the company provided does not establish either. Accordingly, nothing in the materials submitted indicates that determining employee-measured frequency was administratively difficult.

If we assume that the Company could establish administrative difficulty, then use of the employer-measured frequency standard would be appropriate. Under this standard, the frequency with which the employer provides similar fringe benefits is determined by reference to the frequency with which the employer provides the fringe benefits to the workforce as a whole. The focus of this analysis is not whether an individual employee received a particular benefit but rather whether the benefit was provided to employees so frequently that, given the value of the benefit, the provision of the benefit could not properly be characterized as a de minimis fringe benefit. Generally, this analysis requires determining the number of times particular or similar benefits were provided to employees.

In this case, all of the expenses at issue are contained in the designated accounts. For the purpose of this advice, we assume that all similar benefits, for example all group meals, provided by the Company are accounted for in the designated accounts. In other words, there would be no expense items in other numbered accounts for group meals. If this assumption is not correct, the materials submitted cannot establish the number of times particular or similar benefits were provided to employees, and therefore, cannot establish the frequency with which such benefits were provided to the workforce as a whole.

Under the employer-measured frequency standard, the total number of times similar benefits were provided to employees must be established. As we understand the facts in this case, a random sample of the total populations of the designated accounts was used to estimate the value of the items in the account that could properly be considered de minimis fringe benefits. The Company estimated the value of purported fringe benefits in the designated accounts by extrapolating the results of the sample. The sample divided the designated accounts into fully deductible, 50 percent deductible and nondeductible baskets and then determined

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the value of each basket. The sample does not divide the designated accounts into groups of similar benefits or baskets (i.e., group meals, coffee and doughnuts, etc.). Without commenting on whether the sample results provide an accurate estimate of the value of purported fringe benefits provided by the Company, the sampling results are silent with regard to frequency (i.e., the actual number of times that similar benefits were provided to employees). Further, the sample cannot comment meaningfully on frequency because it contains only expense items where five or more individuals were present. The sample does not contain expense items where four or fewer people were present, and therefore, cannot establish the total number of times similar benefits were provided to employees. Accordingly, the sample provides no evidence of the number of times similar benefits were provided to employees.

Because the Corporation has failed to establish the frequency with which it provided benefits to its employees, we conclude that the adjustments sought should not be granted.

Value

The lower the value of benefits provided by an employer, the more likely the benefits are properly characterized as de minimis fringe benefits. We understand that the Corporation has estimated that the de minimis fringe benefits it provided in 1996 and 1997 had a value of _____ and _____ respectively. Further, the Corporation asserts that it deducted only 50 percent of the value of these benefits and is entitled to an affirmative adjustment for 1996 and 1997 of \$ _____ and \$ _____ respectively.

The value figures for 1996 and 1997 provided by the Corporation are based on estimates derived from statistical sampling. The Corporation asserts that these estimates accurately reflect the value of the de minimis fringe benefits it provided. These estimates are the only evidence asserting the value of the purported de minimis fringe benefits provided by the Corporation for 1996 and 1997.

Code section 132(e)(1) defines de minimis fringe benefits as 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 employees) so small as to make accounting for it unreasonable or administratively impracticable. Regulation section 1.132-6(a) contains a similar definition. The language of the Code and the Regulations requires an examination of the "value" of benefits provided. The Corporation asked that we modify the statutory and regulatory definition of de minimis fringe benefits by adding the word "estimated" in front of the word value. The Service has not previously issued guidance stating that an estimated value based on statistical sampling or otherwise meets the requirements of Code section 132(e)(1) and Regulation section 1.132-6(a). Without commenting

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on the accuracy or efficacy of statistical sampling, we conclude that based on the facts presented in this case, we need not address the issue of whether an estimate of value meets the requirement of the Code and the Regulations. This conclusion is based on the fact that the Corporation has not submitted evidence to establish that accounting for the benefits provided would be administratively impracticable, and that the Corporation has failed to demonstrate the frequency with which benefits were provided. Without providing evidence of administrative impracticability and frequency, addressing the issues of value and estimated value based on statistical sampling is both moot and hypothetical.

For the reasons set forth above, we conclude that the Corporation has not provided evidence establishing that the expense items for which it is seeking a deduction were de minimis fringe benefits within the meaning Code section 132(e), and therefore, it is not entitled to full deductibility of these expenses under the exception provided in Code section 274(n)(2)(B). Accordingly, the affirmative adjustment sought by the Corporation should not be granted.

Furthermore, the facts as presented provide no assurance that the deductions at issue meet the threshold requirements of Code section 162 for ordinary and necessary business deductions, nor that they would not be disallowed by the provisions of Code section 274(a) and Code section 274(d). Under Code section 274(a), activities constituting “entertainment, amusement, or recreation” are generally disallowed unless they meet certain express requirements or meet the enumerated specific exceptions of Code section 274(e). Under Code section 274(d), deductions of the type at issue here are disallowed unless certain strict substantiation requirements are met. Any attempt to use statistical sampling in pursuit of the deductions at issue here must demonstrate that the requirements of Code sections 274(a) and (d) have been met.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We recognize that this advice may conflict with the approach taken previously by Appeals. However, we reject the arrangement to use a 400-item sample as a basis for settling this case. The 400-item sample is divided into buckets of benefits but this sample does not divide the designated accounts into groups of similar benefits. Accordingly, the 400-item sample contains no evidence (i.e., not actual frequency or even an estimate of frequency) of the number of times similar benefits were provided to employees. Without rejecting a sampling approach in future cases, we have concluded that the Corporation in this case has failed to establish that it provided de minimis fringe benefits to its employees. Essentially, we are cautious about directly ruling out the use of statistical sampling as a means of establishing value, and see no reason to provide guidance on this issue prematurely where such an issue is not squarely presented. The agreement to use the 400-item sample seems to endorse the approach taken by the Corporation to frame the issue as

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whether the use of statistical sampling is an appropriate means of determining value. The issue is whether the Corporation established that the benefits it provided were de minimis fringe benefits. The Corporation has failed to make this demonstration and, therefore, the issue of sampling is irrelevant and premature.



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Please call Dan E. Boeskin at (202) 622-6040 if you have any further questions.

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