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INSIGHT

Business Deductions for Entertainment and Meals

April 6, 2020

Congress has passed several laws in response to the COVID-19 pandemic, including, most recently, the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), which—among its many purposes—provides tax relief to individuals and businesses. Several of the CARES Act's business tax relief provisions were accomplished by temporarily rolling back restrictions on net operating losses and interest deductions that were enacted as part of P.L. 115-97 (sometimes referred to as the Tax Cuts and Jobs Act or TCJA). As Congress continues to assess the need for further responses, it may consider temporarily rolling back other provisions enacted as part of P.L. 115-97. This Insight provides an overview of one such option—the business deductions for meals and entertainment.

Businesses are allowed to deduct a variety of expenses in determining their taxable income. The more that can be deducted, the smaller their taxable income, and the less the business will owe in taxes, all else being equal. The ability of businesses to deduct expenses for meals and entertainment was limited in the TCJA. Although as a whole the law resulted in a tax cut for businesses, by itself this provision restricted the value of the deduction to businesses, thus raising taxable income.

Rules Prior to the TCJA

Prior to the TCJA, no deduction was allowed for activities generally considered to be entertainment, amusement, or recreation ("entertainment"), unless the activity or facility was directly related to or associated with the active conduct of the taxpayer's trade or business—such as a meal with a prospective client. If directly related, the allowed deduction for entertainment was generally limited to 50% of the amount. Similarly, a deduction for any expense for meals generally was limited to 50% of the amount, although meals provided for the convenience of the employer were fully (100%) deductible. (An example of an expense eligible for the deduction for meals *provided for the convenience of the employer* is the cost to run an on-site subsidized cafeteria for employees.) In addition, no deduction was allowed for membership dues with respect to any club or organization.

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IN11313

Changes Made by the TCJA

The TCJA restricted the ability of businesses to deduct meals and entertainment expenses. The TCJA generally disallowed any deduction for entertainment expenses and reduced the deduction for meals provided for the convenience of the employer to 50%, while largely retaining the broad 50% deduction for other business meals.

The TCJA provision continued a longer-term trend of restricting the ability of businesses to deduct expenses associated with meals and entertainment out of concern that the prior law subsidized personal expenditures. For example, the Tax Reform Act of 1986 (P.L. 99-514) and The Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) restricted the allowable percentages for meals and entertainment to 80% and 50%, respectively.

Economic Effects

The entertainment and restaurant industries have been among the industries hardest hit by the COVID-19 pandemic. To date, social distancing and state government closures have cost these industries billions of dollars in sales and resulted in significant job losses. These economic effects have led to President Trump calling for a return to full deductibility for business entertainment and meal expenses. Common criteria used to evaluate stimulative economic policies include their cost effectiveness and timeliness.

Effective short-term stimulus maximizes the increase in output and employment per dollar of budgetary cost. This might colloquially be referred to as the policy's "bang for the buck." Economists more often cite multiplier effects. For several reasons, the bang for the buck of full deductibility for entertainment and meal expenses would likely be relatively small. First, the effects of allowing full deductibility for business entertainment and meal expenses would likely be limited in the short term by current state restrictions limiting the size of gatherings. Second, to the extent that the entertainment and restaurant industries would benefit, the benefit would be indirect. The direct effects would be primarily felt by businesses that use entertainment and meals as part of their development strategies and a gain to businesses currently incurring entertainment and meal expenses. In other words, the direct effects of the change would likely benefit the businesses that are best weathering the COVID-19 pandemic.

The effect of a reduction in taxes from allowing full deductibility for business entertainment and meal expenses would not occur immediately, but instead would be realized several months from now when businesses filed their taxes. This lag would mean that businesses that claimed the deduction would realize any tax savings after the end of their next tax year.

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