

It was an Employee Morale Gathering, not a Christmas Party!

Written by Nick Sanders
Monday, 31 October 2016 00:00

That time when you have to explain to your client that just because the expense is deductible for tax purposes, doesn't make it allowable for government contract cost accounting purposes. . . . In other words, there are a lot of government contractors who don't even *know about* FAR Part 31 and its cost principles, let alone what those cost principles say and how to apply them.

We probably should be writing about the new [proposed DFARS rule](#) dealing with government property, but today it just doesn't seem as important as writing about the FAR Part 31 cost principles. (Sorry property people, No disrespect intended.) Instead, let's talk about 31.205-13 and 31.205-14. In our experience, people get those two cost principles confused and that confusion leads to audit findings.

Contractors like the way 31.205-13 reads. It says (in part) "*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.*"

That seems to say that *any* expenses incurred for purposes of improving employee morale or improving employee performance are allowable. We've seen employers claim expenses of employee barbeques as allowable expenses, citing to this cost principle. (After all, the employees were *a lot* happier after chowing ribs and brisket, weren't they?) Similarly, we've seen Christmas parties (or as they are called today, "holiday parties") claimed as being allowable expenses under a similar rationale—even though those parties were quite lavish and included alcohol and entertainment. We've seen entire departments head to the bowling alley after work, where somebody submits an expense report claiming allowable employee morale expense. We've seen one-on-one supervisor/employee lunches and dinners claimed as being allowable "performance reviews" (which meant they were claimed to be allowable because they were intended to improve employee performance). Quite honestly, we've seen it all and most of it was claimed as an allowable expense under this cost principle.

But the cost principle is not as permissive as it may seem as first glance. It contains some restrictions, including—

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“Costs of gifts are unallowable.” (Note: the cost principle clearly excludes from this prohibition “awards made in recognition of employee achievements pursuant to an established contractor plan or policy.”)

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“Costs of recreation are unallowable, except for the costs of employees’ participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work, or physical fitness.”

Thus, those bowling alley “morale improvement” gatherings are clearly unallowable, because bowling is a recreational activity, and the costs of recreation are expressly unallowable. Similarly, those season tickets you handed out to employees are also unallowable, either under the “no gifts” language or under the “no recreation” language.

However, costs of sponsoring employee after-work sports teams are clearly allowable under this cost principle, as are costs of employee gyms/fitness centers. So, in theory, you could sponsor an employee bowling team if you could assert (with a straight face) that it led to improved employee fitness.

Having said all that, we need to now turn our attention to 31.205-14 (“Entertainment Costs”). You need to read the permissive language of 205-13 in conjunction with the language of 205-14 in order to make the right call on cost allowability. The 205-14 cost principle is simple. It states—

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.

Importantly, the 205-14 cost principle also states “Costs made specifically unallowable under this cost principle are not allowable under any other cost principle.” Thus, the language in the

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205-14 cost principle overrides the language in the 205-13 cost principle. (You can thank ICF Kaiser for the additional language. ICF Kaiser is a no-longer-in-existence government contractor whose Christmas parties were legendary and who used the 205-13 cost principle language to justify the allowability of the costs.¹)

What this all means is that you can't make your parties at the local bar allowable by calling them "employee morale activities" under the 205-13 language because all "social activities" are already made expressly unallowable by the 205-14 language. Similarly, you can't make your year-end program reviews allowable if they are held at a venue whose purpose is entertainment or amusement. We mean: you can *try*. But your auditors are rightfully going to be extremely skeptical.

How does one successfully navigate this minefield? How does one maximize the cost allowability of legitimate employee gatherings whose primary purpose is to really, honestly, to improve employee morale, communication, and performance?

First, if you are going to hold an employee gathering offsite (no matter where) you need to have an agenda that supports your business purpose. And we're not talking about a 15 minutes speech by the Division President, followed by a general cry of "the bar is now open!" There needs to be an agenda and it needs to support the concept that the purpose of the meeting is other than entertainment, amusement, or an open bar social activity.

Second, you need to keep an attendee list. The attendee list supports the notion that the offsite meeting was business related. And if the attendees include spouses or significant others, that's going to be a red flag to the auditors that there was more going on here than a business meeting. Similarly, if the attendees include subcontractors or suppliers, that's going to be a different red flag.² Finally, if the attendees include your customers (*e.g.*, government employees), that's going to be a different red flag—one you really don't want to wave unless you have really, really, researched government employee ethics rules. The perfect attendee list is filled only with employees (but of course you want the attendee list to be accurate).

If you have "red flag" attendees, you will want to develop a ratio of the unallowable attendees to total attendees, so that a pro rata share of otherwise allowable costs can be moved to unallowable.

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With respect to the costs of the meeting, you will want to segregate “entertainment” and other unallowable costs from costs such as food and non-alcoholic beverages, which are allowable. The DJ? Unallowable. The open bar? Unallowable. Et cetera. The facility rental and general wait service will more than likely be allowable, but watch gratuities for the bartenders, which of course are unallowable.

Finally, watch the communications. If your employee email and check requests call the gathering a “Christmas Party” or “Holiday Party” then you’ve shot yourself in the foot and you may as well not worry about all the analysis discussed above. You’ve declared your purpose—and it’s an unallowable purpose. All costs are now unallowable as well. If you really believe that the purpose of your employee gathering is in line with what the 205-13 cost principle says is allowable—and not what the 205-14 cost principle says is unallowable—then make sure all your communications reflect that purpose. Don’t permit people to be lazy with respect to describing the gathering.

One more thing: timekeeping. If you are going to claim the employee gathering as an allowable meeting, then it’s business-related and you are going to have timekeeping issues. You can’t say on one hand the gathering is an employee morale/performance improvement event while on the other hand saying people are attending on their own time. That might work with your exempt employees, but you are running a big risk with respect to your non-exempt and hourly employees. And what about expense reports for local mileage and parking?

The point is, you had better think this through. It might be easier and cheaper to call a gathering a voluntary party and write all expenses off to unallowable, as opposed to trying to claim a percentage of the expenses as allowable costs while having to deal with the timekeeping and directly associated travel expense aspects.

Now let’s talk about reasonableness. There’s another cost principle (31.201-2) that requires a cost to be reasonable in amount in order for it to be allowable. There’s yet another cost principle (31.201-3) that discusses how to determine if a cost is or is not reasonable in amount. You can do all the math in the world to identify what you believe to be allowable costs, but if the auditors believe the costs to be unreasonable you will have to justify why they are reasonable—and the burden of proof will be on you, the contractor. Government employees are going to have a hard time with a party at the Ritz Carlton or the Four Seasons hotel as being reasonable in amount. They are going to have a hard time with lobster and prime rib being viewed as reasonable meals at employee offsite meetings. Think about the concept of reasonableness before you decide to start claiming costs as being allowable.

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But if you've done your homework and are ready to support your costs through government audit, there's no reason you shouldn't claim reasonable bona fide expenses that are intended to improve employee morale and/or performance as being allowable.

¹ Why, yes. I *am* a former employee of ICF Kaiser. Why do you ask?

² What about supplier conferences where the company gathers its suppliers for purposes of communication and performance improvement? Different thing. Related, though—because you need to watch out for the entertainment aspects of all gatherings. But supplier conferences are a topic for a different article.