Office of Chief Counsel
Internal Revenue Service

memorandum

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to:

from: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

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subject: Application of §274(e)(2) to Expenses for the Personal Use of Corporate Aircraft
POSTF-102493-03

This Chief Counsel Advice responds to your requests for advice dated January 10, 2003 and April 23, 2003. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer	=
Tax Year X	=
$A	=
$B	=
$C	=
$D	=
$E	=
F	=
G%	=
Activity	=

ISSUE

Whether I.R.C. § 274(a)(1)(A) disallows an S corporation's deductions for the amount of expenses (described below) of providing corporate aircraft for the personal use of a shareholder or employee, in excess of the value of the flights included in the shareholder's or employee's income under the methodology of Treas. Reg. § 1.61-21(g).

CONCLUSION

I.R.C. § 274(a)(1)(A) does not disallow an S Corporation's deductions for any portion of the expenses of providing corporate aircraft for the personal use of a shareholder or employee, if the corporation includes the value of each flight in the shareholder's or employee's income under the methodology of Treas. Reg. § 1.61-21(g). Section 274(e)(2), as interpreted in Sutherland Lumber - Southwest Inc. v. Commissioner, 114 T.C. 197 (2000), aff'd 255 F.3d 495 (8th Cir 2001), excepts the type of expenses in this case from the section 274(a)(1)(A) disallowance. The Service acquiesced in Sutherland in AOD 2002-02 (February 11, 2002).

FACTS

Taxpayer is a Subchapter S Corporation primarily engaged in Activity. Taxpayer has F shareholders who are all members of a single family. Taxpayer owns fractional interests in two jet aircraft. Taxpayer presented flight logs that documented business use of the aircraft at approximately 5 percent with the remaining 95 percent being personal use[1] by the shareholders and two non-family employees.

In Tax Year X, Taxpayer incurred operating expenses on the aircraft of $A and depreciation of $B. The total of these sums $C constituted the total expenses (and deductions) for maintaining the aircraft. The deduction for these expenses flowed through the S Corporation to the F shareholders on their Tax Year X individual tax returns.

For Tax Year X, Taxpayer properly determined the SIFL value of each personal use flight under Treasury Reg. § 1.61-21 and reported that value in the compensation and in the wages of the appropriate shareholder or employee.[2] The aggregate value of the personal use flights totaled approximately $D. More than three-quarters (G%) of the $D was

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[1] The term "personal use" should be clarified. The flights provided to the employees and shareholders are fringe benefits. The assets used by Taxpayer to provide the fringe benefits (the aircraft travel) are business assets. They are used by the Taxpayer for a business purpose under § 162, i.e., to compensate employees and shareholders. In the absence of factual development to the contrary, we assume that the airplane expenses are ordinary and necessary business expenses and reasonable in amount. See Kurzet v. Comm'r., 222 F.3d 800 (10th Cir. 2000)(reversing for clear error the Tax Court's factual finding in id., T.C. Memo 1997-54, that expenses for use of an airplane were unreasonable).

[2] The facts do not make it clear whether one of the family members, who lived at a distance from the headquarters of the S Corporation, performed services as an employee or in some other capacity. As will be seen, the result under § 274 is not affected. We are assuming, however, that the family member did provide services to the S Corporation and received the personal use flights in connection with the performance of those services. See § 1.61-21(a)(4).

attributable to the shareholders, and the remainder was attributable to the employees. The shareholders' income for personal use of the aircraft was offset by the $C of aircraft expenses flowing through the S Corporation. Because the $C of deductible expenses was more than 10 times the $D of income included by the shareholders and employees, the shareholders claimed a very significant net deduction for the expenses of the personal use of the S Corporation's aircraft, much of which was attributable to use by them or other family members.

LAW AND ANALYSIS

1. The Statutory and Regulatory Framework

Section 274(a)(1)(A) disallows the deduction of otherwise allowable expenses for activities constituting entertainment, amusement, or recreation, unless the expense is shown to be either directly related to or associated with the active conduct of a trade or business. A vacation or personal trip aboard a company aircraft constitutes entertainment under § 1.274-2(b)(1). However, a taxpayer's costs of providing fringe benefits, like entertainment, may be deductible as § 162 business expenses, if the taxpayer includes the value of the fringe benefits in the recipient's income. Section 1.162-25T.

Entertainment expenses that are included in an employee's income are excepted from § 274(a) disallowance. Section 274(e)(2) excepts:

> Expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of chapter 24 (relating to withholding of income tax at source on wages).

Section 1372 provides that a 2% or greater S corporation shareholder is treated as a partner and the S corporation is treated as a partnership for purposes of applying the employee fringe benefit rules. Section 1.707-1(c) provides that a partner receiving compensation for services performed for the partnership is treated as a person who is not a partner. The partner must include the compensation as income under § 61(a) and the partnership may deduct the compensation under § 162(a), but the partner is not regarded as an employee of the partnership.

Costs of entertaining the shareholders of an S Corporation are similarly excepted from the disallowance by § 274(e)(9), if the S Corporation reports the value of the benefit to the shareholder on the S Corporation's information return (and shareholder payee statement).

Congress made § 274(e)(9) permanent in the Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605. Congress intended that a rule similar to § 274(e)(2) should apply to "facilities" (fringe benefits) "provided to nonemployees" so long as there was income inclusion and information reporting. H. Rep. No. 1278, 96th Cong. 2d Sess., *reprinted in* 1980-2 C. B.

709, 719. The Senate report discussed manufacturers' expenses for entertaining independent dealers and their salesmen as the type of expenses subject to § 274(e)(9). The report indicates that Congress intended to exempt the manufacturer from the § 274(a) deduction disallowance if the value of the entertainment is includable in the income of the recipient and the manufacturer complies with any required information reporting. S. Rept. No. 498, 96th Cong., 1st Sess., *reprinted in* 1980-1 C.B. 517, 545-46.

Neither § 274 nor the legislative history address the method of determining the value of the fringe benefit to be included in the recipient's income. However, Treas. Reg. § 1.61-21(g) provides a methodology for calculating the value of employer-provided vacations or flights on a corporate aircraft. The methodology is known as the Standard Industry Fare Level (SIFL) rate. Section 1.61-21(a)(4)(ii) provides that the person to whom a fringe benefit is taxable may be, for example, a partner or independent contractor.

2. Case Law

In Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000), aff'd 255 F.3d 495 (8th Cir. 2001), the Service contended (1) that the § 274(e)(2) exception applied only to the amount included in employee compensation and wages and (2) that section 274(a) disallowed any deduction for the flight expenses exceeding the amount treated as the employee's compensation and wages. In effect, the Service viewed § 274(e)(2) as a limitation on the deductible amount rather than an exception to the § 274(a) disallowance.

In determining that § 274(a) did not disallow the deductions in Sutherland, the Tax Court concluded that when an employer includes in the employee's income the value of the vacation flight as determined under the fringe benefit rules of Treas. Reg. § 1.61-21(g), the employer satisfies the requirements of the exception to the deduction disallowance in section 274(e)(2) with respect to the vacation flight. Thus, the Tax Court ruled that by treating as wages an acceptable *portion* of the expenses of providing the vacation flights, as required under §1.61-21(g), Sutherland entitled itself to a deduction for the *entire* amount of the expenses incurred in providing the vacation flights. The Court read § 274(e)(2) as an exception to the § 274(a) disallowance rather than a limitation on the deductible amount. The Court reasoned (1) that Congress understood how the SIFL valuation of recipient's income could differ from the provider's deductible cost of providing the benefit to the recipient, but (2) that Congress chose to permit the "mismatch."

In AOD 2002-02 (Feb. 11, 2002), the Service acquiesced in Sutherland. The AOD stated that the Service "will no longer litigate this issue in cases in which a taxpayer demonstrates that it has properly included in compensation and wages the value of an employee vacation flight in accordance with Treas. Reg. § 1.61-21(g)." The AOD stated that in such cases "the Service will allow the taxpayer a full deduction for the cost of the flight." Nothing in the AOD indicates that the Service would attempt to limit the deduction under § 274(a), or construe the exception under § 274(e)(2) differently, where the personal use of the aircraft exceeds a certain percentage of the total usage.

Here, Taxpayer has included the value of the flights under the SIFL rates in the income of the recipients for the year at issue just as the taxpayer in Sutherland did. The case at issue is identical to Sutherland except for the status of the recipients. In Sutherland, a C Corporation provided aircraft use to its president and vice-president (employees). In this case, an S Corporation provides aircraft use to both employees[3] and shareholders. The distinction is the passthrough of the deductions to the shareholders of the S corporation. The benefits to the shareholders in this case are governed by § 274(e)(9) rather than section 274(e)(2) which applies to employees.

We do not think the distinction is significant. Congress intended to treat income inclusion as the condition for excepting expenses from the § 274(a) disallowance regardless of the recipient's status as an employee or nonemployee. Therefore, the rationale of ***Sutherland*** and the AOD would apply to except all of Taxpayer's costs of providing the flight benefits to shareholders. We believe that Congress meant the § 274(e)(9) exception to apply to entertainment provided to partners and Subchapter S shareholders just as the § 274(e)(2) exception applies to entertainment provided to employees.

Accordingly, under Sutherland and current Service position, we conclude that § 274(a) does not disallow the deductions at issue here.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

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[3]Sutherland controls the deductibility of the Taxpayer's expenses for its employees' flight benefits under § 274(e)(2).