Internal Revenue Service

memorandum

CC:LM:CTM:SEA:TL-N-935-01
KGMedleau

Date: FEB 15 2001

To: Martin Townsend, E:1503 MS A153

From: Office of Counsel (Seattle)

Subject: [redacted] - Review of Statutory Notice of Deficiency

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On February 7, 2001, you faxed us your informal request that we review a proposed statutory notice of deficiency (SNOD) covering [redacted] calendar tax year [redacted] (with statute expiration date of [redacted], and proposing a deficiency in its Federal income taxes in the amount of $[redacted] The deficiency results from the Service's (1) disallowance of $[redacted] of [redacted]'s claimed deduction of $[redacted] for the aviation expenses incurred in its use of a corporate jet; (2) disallowance of [redacted]'s entire claimed deduction of $[redacted] for the aviation expenses incurred in its use of a Cessna airplane; and (3) increase in [redacted]'s income of $[redacted] for interest income earned on loans that [redacted] had failed to accrue interest income because it had placed the loans in nonaccrual status as nonperforming loans.

As for the proposed disallowance of a portion of the corporate jet and all of the Cessna aircraft aviation claimed expenses, we concur that [redacted] is not entitled to deduct the aviation costs related to the personal use of the airplanes. However, we were unable to ascertain the extent of the business vs. personal use of the two airplanes from the administrative file. Also, in so concurring, we realize that the Service lost the same corporate jet issue in Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000). However, the Service believes that the case was wrongly decided and

has appealed it to the Eighth Circuit. Thus, at the present time, we believe the Service should continue to propose this adjustment.

As for the proposed increase in [redacted]'s interest income, based on our review of the administrative file, we conclude that [redacted] failed to provide adequate support for the nonaccrual of interest totaling $[redacted] but that [redacted] has established reasonable doubt as to the collectibility of interest on loans totaling $[redacted]. We understand that Examination (Exam) has asked [redacted] for an extension of the statute of limitations for [redacted]. We concur as [redacted] (b)(5)(AC), (b)(7)a [redacted]. Absent obtaining such an extension, (b)(5)(AC), (b)(7)a [redacted]. In addition, we also recommend that the SNOD language reflect that (b)(5)(AC), (b)(7)a [redacted].

Accordingly, we are closing our files in this matter concerning [redacted]'s [redacted] tax year as of this date. The rationale for our legal conclusions and recommendations, as well as our understanding of the facts upon which they are based, are set forth below.

FACTS

Aviation Expenses

[redacted] owns a Cessna airplane and a corporate jet. Exam determined that the Cessna airplane was not used for business purposes during [redacted]. Exam also determined that, based on total flight hours, the corporate jet was used approximately [redacted]% for business purposes during [redacted], and that the other [redacted]% of use was primarily for the personal benefit of certain officer-shareholders who were "controlled employees" within the meaning of Treas. Reg. § 1.61-21(g).

For federal income tax purposes, [redacted] treated the expenditures allocable to the use of its Cessna airplane and corporate jet as if all of the flights were undertaken for business purposes. That is, [redacted] deducted its total expenditures allocable to the aircrafts, $[redacted] for the Cessna and $[redacted] for the jet. In addition, [redacted] determined the value under Treas. Reg. § 1.61-21(g) of the [redacted] corporate jet flights

undertaken for the personal benefit of certain officer-shareholders who were "controlled employees" to be $[redacted] treated this amount as compensation to the officer-shareholders and included this amount in their respective wages on the [redacted] Form W-2 issued to them by [redacted] for income tax withholding purposes.

Nonaccrual of Interest Income

[redacted] is an accrual basis taxpayer engaged in the business of [redacted]. Pursuant to the applicable regulatory authority and its own pertinent corporate policy, [redacted] accounts for its commercial, real estate, consumer, and credit card loans under the so-called "conformity election" of Treas. Reg. § 1.166-2(d)(3) by establishing a conclusive presumption of worthlessness for these loans that are deemed "loss assets" under the regulation.

Loans that are "loss assets" under the regulation are written off for both book and tax purposes and [redacted] ceases accruing interest on such loans. No adjustments to [redacted]s tax treatment of those loans are proposed by Exam in the SNOD and [redacted]s tax treatment of these loans are not at issue. However, pursuant to [redacted] policy, [redacted] also ceases accruing interest on certain commercial and real estate loans that are not "loss assets" and, thus, fall outside the regulation's presumption of worthlessness.

Specifically, pursuant to [redacted] policy, all commercial and real estate loans past due [redacted] days (regardless of dollar size) are placed in nonaccrual status on its books for financial and tax purposes and classified at least substandard, unless an exception is granted by Senior Loan Administration. The loan is considered delinquent if either principal or interest is past due, including loans that mature. Interest is accrued on loans past due [redacted] days or more only when management has ascertained that collection of the interest is assured and imminent. For loans placed in nonaccrual status, any previously accrued interest during the [redacted]-day period is deducted as a bad debt for book purposes, but not for tax purposes.

[redacted]s nonaccrual of interest on the commercial and real estate loans placed in nonaccrual status is the subject of Exam's proposed SNOD adjustments to income. Specifically, Exam proposes increasing [redacted]s [redacted] income by $[redacted] for interest income earned on these loans that [redacted] had failed to accrue interest income. As discussed below, whether [redacted] properly failed to accrue interest on these loans is a factual question because loans can be uncollectible or worthless despite not meeting the Treas. Reg. § 1.166-2(d)(3) "loss assets" requirements.

LAW and ANALYSIS

Aviation Expenses

Under section 162, a taxpayer may deduct the ordinary and necessary expenses of carrying on a trade or business, and section 167 allows a deduction for depreciation of property used in a trade or business.[1] However, under section 161, these deductions are subject to the limitations imposed by section 274.

Section 274(a)(1)(A) generally provides that no deduction otherwise allowable shall be allowed for any item with respect to an activity of a type generally considered to constitute entertainment, amusement or recreation. Section 274(a)(1)(B) provides the same deduction disallowance for a facility used in connection with an activity referred to in section 274(a)(1)(A).

Treas. Reg. § 1.274-2(b)(1)(i) provides that the term "entertainment" means any activity of a type generally considered to constitute entertainment, amusement or recreation, such as entertaining on hunting, fishing, vacation and similar trips. Treas. Reg. § 1.274-2(e)(2)(i) defines a facility used in connection with entertainment generally as any item of personal or real property (including airplanes) owned, rented or used by the taxpayer for (or in connection with) entertainment. Expenditures with respect to a facility used in connection with entertainment include depreciation and operating costs. Treas. Reg. § 1.274-2(e)(3)(i).

Treas. Reg. § 1.274-2(b)(1)(iii) provides special definitional rules for expenditures that might be considered paid or incurred either for travel or for entertainment. Generally, such expenditures are considered to be expenditures for entertainment under Treas. Reg. §1.274-2(b)(1)(iii)(a). However, Treas. Reg. §1.274-2(b)(1)(iii)(c) provides this exception:

> (c) Expenditures deemed travel. An expenditure described in (a) of this subdivision shall be deemed to be for travel to which this section does not apply if it is:
>
> (1) With respect to a transportation type facility (such as an automobile or an airplane), even though used on other occasions in connection with an activity of a type generally considered to constitute entertainment, to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment. (emphasis added).

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[1] Section 168 provides the applicable depreciation method, applicable recovery period and applicable convention for use in determining the section 167 depreciation deduction for tangible personal property.

Section 274(e) also contains specific exceptions to the application of the deduction disallowance rules of section 274(a). Section 274(e)(2) provides for an exception from these rules for 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 income tax return and as wages to the employee for purposes of withholding of income tax at the source on wages. See also, Treas. Reg. § 1.274-2(f)(2)(iii). As an example, Treas. Reg. § 1.274-2(f)(2)(iii)(C) provides that if an employer rewards the employee (and the employee's wife) with an expense-paid vacation trip, the expense is deductible by the employer (if allowable under section 162 and the regulations thereunder) "to the extent the employer treats the expenses as compensation and as wages."

Under section 61(a)(1), fringe benefits are includible in gross income. Treas. Reg. § 1.61-21(g) sets forth the non-commercial flight valuation rule for determining the fringe benefit amount includible in gross income.

We concur that [redacted] is not entitled to deduct the aviation costs related to the personal use of the Cessna aircraft and corporate jet. However, we were unable to ascertain the extent of the business vs. personal use of the two airplanes from the administrative file. Also, in so concurring, we realize that the Service lost the same corporate jet issue in Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000). However, the Service believes that the case was wrongly decided and has appealed it to the Eighth Circuit. Thus, at the present time, we believe the Service should continue to propose this adjustment.

Nonaccrual of Interest Income

Under the accrual method of accounting, income – including interest income – is included in gross income when all events have occurred that fix the right to receive that income and the amount thereof can be determined with reasonable certainty. Treas. Reg. § 1.451-1(a). Generally, the right to receive interest income becomes fixed ratably over the period of a loan, so long as the requirements of the aforementioned "all-events test" have been met. See Hunt v. Commissioner, T.C. Memo. 1989-335.

A fixed right to a determinable amount, nevertheless, does not require accrual if that amount is in fact uncollectible or there is a reasonable doubt as to its collectibility when the right to receive the income item arises. It was well established long ago that "it would be an injustice to the taxpayer to insist upon taxation" of such items. Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930; Clifton Mfg. Co. v. Commissioner, 137 F.2d 290 (4th Cir. 1943); European Am. Bank & Trust Co. v. United States, 90-2 USTC ¶50,333 (Cl. Ct. 1990); Turners Falls Power & Electric Co. v. Commissioner, 15 B.T.A. 983 (1929). Furthermore, where the right to receive income is

actually "without substance" there is "in fact nothing to accrue." Atlantic Coast Line R.R. Co. v. Commissioner, 31 B.T.A. 730, 751 (1934), aff'd 81 F.2d 309 (4th Cir. 1936). This view consistently has been upheld. See e.g., Jones Lumber Co. v. Commissioner, 404 F.2d 764 (6th Cir. 1968); Georgia School Book Depository v. Commissioner, 1 T.C. 463 (1943); Hunt v. Commissioner, supra; Harrington v. Commissioner, T.C. Memo. 1972-1681; Rev. Rul. 80-361, 1980-2 C.B. 164.[2]

While very few cases have focused on the level of uncertainty or uncollectibility necessary to preclude accrual, reasonable doubt as to the collectibility of an income item may be established by reason of the financial condition, insolvency, or other circumstances affecting the debtor or the obligation (e.g., adequacy of collateral and state of the economy). See e.g., Procacci v. Commissioner, 94 T.C. 397, 416, n. 10 (1990) ("[i]f it is reasonably certain that the income will not be collected in the tax year or within a reasonable time thereafter, the taxpayer is justified in not accruing the item"); Jones Lumber Co. v. Commissioner, supra at 766-767 (although finding that the income had to be accrued, the court suggested that insolvency of the debtor is not required in order to show a reasonable doubt and that the course of dealing between the parties and any irregularity of payments are factors to be considered); Bank of Kirksville v. United States, 943 FSupp. 1191 (Dist. Ct. Western District Mo. 1996) (Bank had a specific policy for putting loans on nonaccrual status where loans were delinquent for at least 90 days and when the Bank determined it was unlikely that the debt would ever be paid. Court held that the Bank properly did not accrue interest on the loans placed in nonaccrual status); Rev. Rul. 80-361, supra (the Service ruled that the taxpayer-creditor should accrue interest up to the time of the debtor's insolvency).

Thus, whether nonaccrual of interest is appropriate on the commercial and real estate loans placed in nonaccrual status depends on whether the interest was uncollectible (or there was reasonable doubt as to its collectibility) at the time [redacted]'s right to the interest income became fixed and determinable.[3] This is a loan-by loan

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[2] When interest properly accrues but subsequently becomes uncollectible during the same taxable year, a taxpayer's course of remedy should be by way of bad debt deduction rather than elimination of the accrual itself. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934). In those situations, by definition, the right to receive income does have genuine substance when it arises. The practical effect, of course, is likely of little difference to the taxpayer.

[3] Under the reasoning of Rev. Rul. 81-18, 1981-1 C.B. 295, and the FSA issued to [redacted] dated [redacted] properly did not accrue interest income on its nonperforming loans that were "loss assets" under Treas. Reg. § 1.166-2(d)(3) and, thus, conclusively presumed worthless.

determination. We reviewed the documentation in the administrative file (consisting primarily of [redacted]'s change to nonaccrual status documents) on a loan by loan basis to determine whether [redacted]'s nonaccrual of interest was warranted – i.e., whether there was a reasonable doubt as to the collectibility of the interest income on these loans.

Exam's proposed $[redacted] income adjustment relates to all of the commercial and real estate loans ([redacted] in total) that were in nonaccrual status for [redacted]. Specifically, on its [redacted] Annual Financial Statement, [redacted] had reported a total of $[redacted] in nonaccrued interest on these loans, but had made an $[redacted] schedule M1 adjustment for these items, netting to $[redacted] of unaccrued interest for tax purposes.

Of this amount, our review of the administrative file was as follows: (1) for [redacted] loans, [redacted] failed to provide adequate support for the nonaccrual of interest totaling $[redacted] and (2) for the remaining [redacted] loans, [redacted] failed to establish reasonable doubt as to the collectibility of interest on [redacted] loans totaling $[redacted] but we believe ([redacted] (b)(5)(AC), (b)(7)a [redacted]. Attached as Addendum A is our loan by loan analysis of the [redacted] loans for which [redacted] provided documentation. We understand that Exam has asked [redacted] for an extension of the statute of limitations for [redacted]. We concur as an extension [redacted] (b)(5)(AC), (b)(7)a [redacted]

Absent obtaining such an extension, [redacted] (b)(5)(AC), (b)(7)a [redacted].

In addition, we suggest the following SNOD language [redacted] (b)(5)(AC), (b)(7)a [redacted]:

[redacted] (b)(5)(AC), (b)(7)a [redacted]

RECOMMENDATION

As for the proposed disallowance of a portion of the corporate jet and all of the Cessna aircraft aviation claimed expenses, we concur that [redacted]'s not entitled to deduct the aviation costs related to the personal use of the airplanes. However, we were unable to ascertain the extent of the business vs. personal use of the two airplanes from the administrative file. Also, in so concurring, we realize that the Service lost the

same corporate jet issue in Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000). However, the Service believes that the case was wrongly decided and has appealed it to the Eighth Circuit. Thus, at the present time, we believe the Service should continue to propose this adjustment.

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If you have any questions or if we could be of any more assistance, please do not hesitate to call the undersigned at (206) 220-5951.

/s/ KGM

KEITH G. MEDLEAU
Senior Attorney - LMSB