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FROM: Matthew J. Fritz, Associate Area Counsel (LMSB)
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SUBJECT: [redacted]
TIN: [redacted]
Airplane Issues

This memorandum responds to your request for assistance dated January 21, 2001. This memorandum should not be cited as precedent.

ISSUES

1. Whether the taxpayer's reliance on Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000), which appears to allow a deduction for airplane expenses, usurps the Service's ability to request information relating to the airplane expenses claimed on its return?

2. Under what circumstances is the taxpayer entitled to deduct airplane expenses incurred in the taxable year on its return?

3. Assuming the airplane expenses are not deductible and therefore should be disallowed, what method of disallowance should be used?

4. What is the Service's position with regard to the holding in Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000)?

CONCLUSIONS

1. No. Under I.R.C. § 7602(a)(1), the Service is authorized to examine any books, papers, records, or other data which may be relevant to determining the liability of any person for any internal revenue tax.

2. The taxpayer must prove that the expenses are allowable under a specific statutory provision allowing the deduction.

3. Based on the circumstances of this case, the proposed method of disallowance is reasonable.

4. The holding of Sutherland is not applicable to this case. Nevertheless, the Service's position with regard to Sutherland is that the case should not be followed.

FACTS

The facts as we understand them follow: [redacted] is a Kentucky corporation. [redacted] filed consolidated income tax returns for itself and its subsidiaries for the taxable years [redacted] and [redacted]. [redacted] claimed expenses relating to the operation of a corporate airplane.

In response to information document requests issued to the taxpayer pertaining to the deduction of airplane expenses, the taxpayer provided a list detailing flight hours, locations, and individuals flown on various trips. The Service has isolated a portion of these flights ([redacted] hours). These flights appear to relate to trips to various locations, including exotic locales where [redacted] conducts no business, for its male president and a female director. Usually these trips involved an overnight stay.

At this time, the extent of the president's and director's personal relationship is not known. President [redacted] is [redacted] years old. He was divorced in [redacted]. It is believed that [redacted]'s marital status is single. [redacted] maintains a residence in Florida. Director [redacted] is [redacted] years old. It is believed that [redacted]'s marital status is single.

[redacted] has not established a business purpose for these trips. Several trips were made to Florida. According to SEC

filings, the taxpayer rents no office space in Florida. However, the president of the taxpayer owns real property located in Florida. The taxpayer has refused to provide any further information pertaining to these flights citing reliance on the Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000). This case has been appealed by the Department of Justice to the United States Court of Appeals for the Ninth Circuit.

The examination team has inquired about disallowing a portion of the airplane expenses claimed on the return of the corporate taxpayer. The examination team proposes that the disallowance would be based on section 162 and in the alternative section 274(e). The examination team has also requested the Service's current position on the Sutherland case.[1]

The disallowance would be calculated based on a percentage derived from taking the number of nonbusiness hours over the total number of hours flown in the tax year. The percentage would then be multiplied against the total airplane costs to calculate the disallowance. If the adjustment is not appropriate for the corporate return, the examination team indicated that an adjustment could be proposed to the tax returns of the director and the president under section 61. However, if that is the Service's only recourse, it is unlikely that the issue will be pursued any further.

ANALYSIS

Issue 1: Authority of the Internal Revenue Service to Examine Records, Documents, Books, and Other Data

I.R.C. § 7602 grants the Internal Revenue Service broad examination authority to facilitate administration and enforcement of the internal revenue laws. Specifically, section 7602(a)(1) authorizes the Service to examine any books, papers, records, or other data which may be material or relevant to certain specifically identified purposes. The purposes identified include: ascertaining the correctness of a return; making a return where none was made; determining the liability of any person for any internal revenue tax; and collecting any internal revenue tax liability. I.R.C. § 7602(a).

The revenue agent's investigation of the corporation's expenses falls within the purpose of ascertaining the correctness of the consolidated returns filed by the parent corporation, as

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[1] As explained below, we do not think the facts of this case implicate section 274(e) or the Sutherland case.

well as determining the liability of the parent corporation for income taxes. The taxpayer has refused to comply with the revenue agent's requests for information about its expenses relying on a Tax Court decision. Reliance on a case does not invalidate the investigative powers of the Service.

It is not necessary for the revenue agent to first issue a summons before examining records pertaining to the subsidiaries. The Service's authority to examine books, papers, records, or other data exists separately from the Service's authority to summon such records under I.R.C. § 7602(a)(2). See I.R.C. § 7609(j)(nothing in section 7609 is intended to limit the IRS's ability to obtain information other than by summons through formal and informal procedures authorized by sections 7601 and 7602). In fact, it is the Service's policy that information such as that sought by the revenue agent should be obtained informally, without serving a summons. I.R.M. 109.1 Summons Handbook § 1.4 (04/30/1999). However, if the records are not produced voluntarily, the Service can compel compliance by summoning the records and, if needed, the return preparers' testimony.

If the taxpayer fails or continues to refuse to comply with the revenue agent's requests, the Service should consider the issuance of a formal administrative summons to obtain such information.[2] See I.R.C. §§ 7602(a)(2) and (3). A summons would be appropriate in the following situations[3]:

(1) No records are made available to permit an adequate examination within a reasonable period of time;

(2) The records submitted are known or suspected to be incomplete and the examiner believes that additional records containing relevant and material matter may be in the possession of the taxpayer or a third party;

(3) The examiner believes that additional relevant details are being withheld because of an adverse impact on the taxpayer;

(4) The taxpayer indicated that it is withholding substantial records or information for subsequent use

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[2] Area Counsel would be more than willing to offer its assistance in preparation of the summons.

[3] See I.R.M. 109.1 Summons Handbook § 1.4 (04/30/1999).

on administrative appeal or after issuance of a deficiency notice; and

(5) The examiner is in doubt as to the availability of pertinent records, and wishes to obtain oral testimony as to what records exist and their location.

Issue 2: Entitlement to a Deduction for Airplane Expenses

A taxpayer has no absolute right to deductions for they are a matter of legislative grace. New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435, 440 (1934). Consequently, for [redacted] to be entitled to its claimed deductions, it must prove that they fit within the relevant statutory authorization. Welch v. Helvering, 290 U.S. 111, 115 (1933).

I.R.C. § 162(a) permits a taxpayer to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. An expense is ordinary if it bears a reasonably proximate relationship to the operation of the taxpayer's business. Deputy v. Du Pont, 308 U.S. 488, 495-496 (1940). An expense is necessary if it is helpful and appropriate in promoting and maintaining the taxpayer's business. Carbine v. Commissioner, 83 T.C. 356, 363 (1984), aff'd, 777 F.2d 662 (11th Cir. 1985).

The term "ordinary" refers to an expense that is common and acceptable in the taxpayer's type of business. The term "necessary" distinguishes a business expense from a personal expense that is incurred by the taxpayer. In order to qualify as a "necessary expense," the amount need not be vital to the continuation of the business, but must be appropriate or helpful to the business. In addition to being "ordinary and necessary" the Sixth Circuit has held that a business expense must also be "reasonable." Lincoln Electric Co. v. Commissioner, 162 F.2d 379 (6th Cir. 1947). See also Harbor Medical Corp. v. Commissioner, T.C. Memo. 1979-291 (Airplane expenses of the corporation were not "ordinary" expenses, in part, because its business was limited to a single city and the surrounding area.). Whether an expense is reasonable depends upon the facts and circumstances in the particular situation.

Thus, to be entitled to a business expense deduction, a taxpayer is required to substantiate the amount of any claimed expenses, as well as the business purpose of the claimed expenses. See Ellington v. Commissioner, T.C. Memo. 1989-374, aff'd, 936 F.2d 572 (6th Cir. 1991). A taxpayer is required to maintain records sufficient to establish the amount of his or her income and deductions. See I.R.C. § 6001. With respect to every

item of expense which is claimed as a deduction under I.R.C. § 162, a taxpayer must establish: (1) that the expense was paid or incurred; (2) that it was paid or incurred during the taxable year at issue; (3) that it was paid or incurred in carrying on a trade or business; and (4) that the expense was ordinary and necessary. Treas. Reg. § 1.162-1. Under certain circumstances, where a taxpayer establishes entitlement to a deduction but does not establish the amount of the deduction, the Court is allowed to estimate the amount allowable. See Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930). However, there must be sufficient evidence in the record to permit the Court to conclude that a deductible expense was incurred in at least the amount allowed. See Williams v. United States, 245 F.2d 559, 560 (5th Cir. 1957). In estimating the amount allowable, the Court bears heavily against the taxpayer whose inexactitude is of his or her own making. See Cohan, 39 F.2d at 544.

If a taxpayer travels to a destination and, while at such destination, engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is primarily related to the taxpayer's trade or business. See Treas. Reg. § 1.162-2(b)(1). If a trip is primarily personal in nature, traveling expenses to and from the destination are not deductible even if the taxpayer engaged in some business activities at the destination. See id. However, expenses incurred while at the destination that are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

Whether travel is related primarily to the taxpayer's trade or business, or is primarily personal, is a question of fact. See Treas. Reg. § 1.162-2(b)(2); see also Holswade v. Commissioner, 82 T.C. 686, 698-701 (1984). The amount of time during the period of the trip that is spent on personal activity, compared to the amount of time spent on activities directly relating to the taxpayer's trade or business, is an important factor in determining whether the trip is primarily personal. See Treas. Reg. § 1.162-2(b)(2).

In response to the Service's requests for information pertaining to certain airplane expenses, [redacted] has failed to provide the Service with any information that would establish that the expenses incurred in connection with the trips made by its president and a director were reasonably proximate to the operation of the taxpayer's business. [redacted] also has failed to establish that the expenses were helpful in promoting and maintaining the taxpayer's business. Consequently, [redacted] has

failed to establish that a deduction for the expenses would be allowable under I.R.C. § 162.

Issue 3: Method of Disallowance

The examination team proposes disallowing the nonbusiness airplane expenses claimed on the returns of [redacted]. The disallowance would be based on section 162 and in the alternative 274(e)[4]. The disallowance would be calculated based on a percentage derived from taking the number of nonbusiness hours ([redacted]) over the total number of hours flown in the tax year. This percentage would then be multiplied against the total airplane expenses to calculate the disallowance. Absent the taxpayer providing more specific information pertaining to the expenses incurred in connection with the nonbusiness flights, the method of disallowance proposed by the examination team is reasonable.

Issue 4: Service's Position on Sutherland Lumber-Southwest, Inc.

A. Background of Sutherland Lumber-Southwest, Inc.

The Sutherland Lumber-Southwest, Inc. ("Sutherland") provided its employees with the use of a company-owned airplane for travel related to their positions, as well as for travel that did not have any business correlation. Sutherland notified its employees to report the value of the nonbusiness flights as imputed income on their individual income tax returns.

Sutherland calculated and reported the amount of the imputed income for its employees in accordance with the valuation formula provided in Treas. Reg. § 1.61-21(g) on its income tax return. Sutherland deducted all the expenses incurred in providing its employees with business and nonbusiness flights. Relying on I.R.C. § 274(e)(2), the Internal Revenue Service determined that deductions for expenses incurred in providing employees with nonbusiness flights on a company-owned airplane were limited to the amount reported as imputed income by the recipient employees.

Sutherland moved for partial summary judgment solely with respect to the disallowance of a portion of its claimed deduction for expenses to operate the airplane. The Service filed a cross-motion for partial summary judgment. The issue presented to the court was limited to whether Sutherland, under section 274, could

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[4] As discussed below, the alternative reason for disallowance would not fall under section 274(e) but rather 274(a) and 274(d).

deduct its airplane operating costs in full or whether the corporation's deduction was limited to the amount reportable as compensation by its employees. In application of section 274(e), the Tax Court held that the deduction of airplane expenses by an employer was not limited to the amount reported as compensation by its employees.

B. The Service's Position on Section 274(e)

Our understanding of the Service's position on the deductibility of airplane expenses under section 274(e) has been derived from the documents filed with the Tax Court and appeals court in the Sutherland case. In accordance with sections 274(a) and 274(e)(2), the deduction of the expenses allocable to the use of a corporation's plane for the nonbusiness flights should be limited to the amount reported as wages by its employees attributable to those flights.

C. Inapplicability of Sutherland

Assuming that the taxpayer gets beyond the inquiry of deductibility under section 162, the taxpayer still must comply with sections 274(a) and (d). For the reasons that follow, we do not believe that section 274(e)(2) and the holding in Sutherland apply in this case.

Section 274 "Disallowance of Certain Entertainment, Etc., Expenses" provides that:

(a) Entertainment, Amusement, or Recreation. (a)(1) In general. No deduction otherwise allowable under this chapter shall be allowed for any item--

> (A) Activity. With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or
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> (B) Facility. With respect to a facility used in connection with an activity referred to in subparagraph (A).

In the case of an item described in subparagraph (A), the deduction shall in no event exceed the portion of such item which meets the requirements of subparagraph (A).

(d) Substantiation Required. No deduction or credit shall be allowed--

(1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),

(2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,

(3) for any expense for gifts, or

(4) with respect to any listed property (as defined in section 280F(d)(4)),

unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift. The Secretary may by regulations provide that some or all of the requirements of the preceding sentence shall not apply in the case of an expense which does not exceed an amount prescribed pursuant to such regulations. This subsection shall not apply to any qualified nonpersonal use vehicle (as defined in subsection (i)).

(e) Specific Exceptions to Application of Subsection (a). Subsection (a) shall not apply to-

(e)(2) Expenses treated as compensation. 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 274(a)(1)(A) denies 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.

When an employer provides an employee with the use of an airplane for a vacation trip, this is entertainment of the employee. Treas. Reg. § 1.274-2(b)(1)(i) states that "the providing of a hotel room or an automobile by an employer to his employee who is on vacation would constitute entertainment of the employee." Because an employee's vacation is not an activity directly related to or associated with the active conduct of the employer's trade or business, but rather is for the personal enjoyment of the employee, the expenses of providing the use of an airplane for a vacation fail the test of section 274(a)(1)(A).

Section 274(d) substantiation requirements apply to traveling expenses, entertainment items, business gifts, and entertainment items away from home including meals and lodging and entertainment. Under section 274(d), a taxpayer must substantiate the amount of the item, time, place, and business purpose of the expenditures and furnish adequate records or sufficient evidence corroborating his own statement. Treas. Reg. § 1.274-5T(c)(1). Adequate records are defined as an account book, diary, log, statement of expense, trip sheets, or similar records, plus "documentary evidence." Treas. Reg. § 1.274-5T(c)(2). Examples of documentary evidence include receipts, paid bills, or similar evidence to support an expenditure. Treas. Reg. § 1.274-5T(c)(2)(iii)(B).

In addition to failing to meet the requirements of section 274(a)(1)(A), the taxpayer has failed to produce any documentation for the expenses relying on section 274(e)(2). The multifarious assertions of the taxpayer are preposterous and attempt to circumvent the legal requirements of section 274. Section 274(e)(2) makes the requirements of section 274(a) inapplicable where the taxpayer treats the expenses as compensation paid to employees on its return. In this case, section 274(e)(2) does not provide the taxpayer with this limited relief because [redacted] did not treat the airplane expenses as employee compensation. On its tax return, [redacted] did not calculate and report the amount of the imputed income for its employees in accordance with the valuation formula provided in Treas. Reg. § 1.61-21(g). Nevertheless, even if section 274(e) were applicable, the substantiation requirements of section 274(d) still must be satisfied.

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.

This memorandum is subject to post-issuance review by the Office of Chief Counsel, under CCDM (35)3(19)4. We will inform you of any modification of this advice.

If you have any questions, please contact the undersigned at (513) 684-2152.

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