FLIGHT-WATCH

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A CORPORATION WHICH MADE ITS JET AVAILABLE TO EMPLOYEES FOR NON-BUSINESS FLIGHTS COULD DEDUCT THE ACTUAL COSTS OF OPERATING THE AIRCRAFT ON THOSE FLIGHTS, EVEN THOUGH THE EMPLOYEES PAID TAX ON IMPUTED INCOME BASED ON A VALUE BELOW THE ACTUAL COSTS OF OPERATING THE AIRCRAFT.

I.

INTRODUCTION

It is a common practice for corporations to make their aircraft available for use by key personnel (such as officers and directors) in relation to non-business flights. The corporation will then deduct the actual operating costs for those flights on its income tax return, even though the employees who used the aircraft paid tax for imputed income determined by a multiplier of the Standard Industry Fare Level ("SIFL") based on coach or first-class air fare costs. As one might expect, the corporate employees may pay income tax on an amount of money substantially less than the amount deducted by the corporation on its tax return in relation to providing the aircraft to the employees for non-business flights. This article will examine *Sutherland Lumber-Southwest, Inc. v. Commissioner of the Internal Revenue Service*[1*], a case in which the United States Tax Court approved this procedure and gave a very clear explanation with respect to why this tax treatment is appropriate.

II.

THE FACTS IN *SUTHERLAND*

Sutherland Lumber-Southwest, Inc. ("Sutherland") had its principal place of business in Kansas City, Missouri and was engaged in the retail lumber business with outlets in eight Texas cities. It owned a 1976 Learjet, Model 25, which was used for (1) travel related to the lumber business, (2) air charter operations, (3) travel for the president and vice-president as directors of other business (directors' flights), and (4) travel for other businesses and charitable purposes (non-vacation flights), and (5) vacation travel (vacation flights). In 1992, the aircraft was used: 30% for charter flights, 23% for directors' flights, 18% for non-vacation flights, 24% for vacation flights and 5% for other purposes.

The president and vice-president reported the directors' flights, non-vacation flights, and vacation flights on their income tax returns as compensation and paid the income tax. The corporation deducted the costs of aircraft operation on its income tax return, including the actual operating costs for the directors' flights, the non-vacation flights and the vacation flights. The IRS agreed that the corporation correctly applied and calculated the imputed income and deduction figures pursuant to Sections 61 and 162 of the Internal Revenue Code. However, relying on Section 274(a), the IRS claimed the corporation could not deduct as the value of the flights more money than the corporate officers had declared as the value of the flights, based on the SIFL formula. Accordingly, the IRS sought to collect tax deficiencies from the corporation of $341,631 for 1992 and $119,558 for 1993. The alleged deficiencies arose out of a difference of opinion between the IRS and the corporation about the amount the corporation could deduct in providing the aircraft to the president and vice-president for flights not related to the corporation's business.

III.

THE LEGAL ISSUE IN *SUTHERLAND* AND THE TAX COURT'S DECISION

The issue in *Sutherland* was whether Section 274(e)(2) of the Internal Revenue Code limited the corporation's deductions for the non-business flights to the value of benefits declared by the corporate employees on their tax returns based on SILF or whether the corporation could deduct the actual costs of those flights as compensation to the president and vice-president. Both the corporation and the IRS filed motions for summary judgment. The corporation's motion was granted. The motion of the IRS was denied. The corporation's deduction for the actual costs of the non-business flights as additional employee compensation was allowed. The tax deficiencies assessed by the IRS of $461,189 were overturned. The legal and regulatory basis for this decision by the Tax Court is discussed below.

A taxpayer is allowed a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business[2]. Expenses are ordinary and necessary if the taxpayer establishes that they are directly connected with, or proximately related to, the taxpayer's activities.[3] Since deductions are a matter of legislative grace, the taxpayer must prove that it is entitled to the claimed deductions.[4]

A taxpayer may deduct expenses paid as compensation for personal services.[5] An employer may take a deduction for expenses incurred in paying a non-cash, fringe benefit which is included in the recipient's gross income.[6] The employer may not deduct the amount included by the employee as compensation, but is required to deduct the employer's costs incurred in providing the benefit to the employee.[7]

Deductions that were previously allowed by Section 162 of the Internal Revenue Code were disallowed after the enactment of Section 274. Section 274 was enacted to curb or eliminate abuses with respect to business expense deductions for entertainment, travel expenses and gifts.[8] With the implementation of Section 274(a)(1)(A), deductions were disallowed for entertainment, amusement, and recreational activities. Section 274(a)(1)(B) disallows the deduction of otherwise allowable expenses incurred with respect to a facility used in connection with such an activity.[9]

While Sections 274(a)(1)(A) and 274(a)(1)(B) disallow entertainment deductions, Section 274(e)(2) **exempts** from the disallowance:

> 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).[10]

Clearly, if the entertainment facility (airplane) is used as compensation to an employee, Section 274(e)(2) **exempts** the deduction from the **disallowance** provisions of Sections 274(a)(1)(A) and 274(a)(1)(B).

The IRS argued the "to the extent" language in Section 274(e)(2) would only permit the corporation to take a deduction for use of the aircraft to the extent of the value included as income on the employees' tax returns. However, the Tax Curt rejected this argument, noting that Section 274(e)(2) is an **exception** from the disallowance provisions of Sections 274(a)(1)(A) and 274(a)(1)(B), and not a mere **limitation** on the extent of the deduction.

The IRS also argued that by enacting Section 274(e)(2), Congress intended to correct the mismatch between the amount declared as income by the employees and the amount deducted by the corporation in relation to use of the aircraft. The Tax Court rejected this argument, noting:

> There is no indication that Congress was attempting to fix any such possible mismatch by enacting Section 274. To the contrary , the legislative history seems to indicate otherwise.[11]

IV.

THE OPINION OF THE EIGHTH CIRCUIT AFFIRMING THE TAX COURT

The IRS appealed the Tax Court's decision to the United States Court of Appeals for the Eight Circuit. The IRS continued to argue that the extent of the corporation's deduction for allowing employees to use the aircraft on non-business flights should be limited to the same value reported on the employees' tax returns. Following a brief discussion of the facts and legal arguments, the Eight Circuit affirmed the Tax Court, noting:

> After a complete review *de novo*, we agree with the Tax Court's well-and affirm on the basis of the analysis set forth therein. See [CCH Dec. 53, 817], 114 T.C. 197 (2000). Because we have nothing of substance to add to the Tax Court's thorough analysis, further discussion is superfluous.[12]

V.

CONCLUSION

The decision by the United States Tax Court, together with the *per curiam* opinion of the Eight Circuit Court of Appeals affirming that decision, indicates that a corporation providing an aircraft for personal use by corporate employees as part of a compensation package may deduct the actual operating expenses associated with providing the aircraft to the employee, even though the employee may place a much lower value for use of the aircraft on his personal tax return.

~Notes~

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[1]*Sutherland Lumber-Southwest, Inc. v. Commissioner of the Internal Revenue Service*, 114 T.C. 197, CCH Dec. 53, 817, United States Tax Court, Docket No. 23936-97, affd. *per curiam* United States Court of Appeals for the Eight Circuit, Docket No. 00-2827 (July 3, 2001), 2001-2 USTC Par. 50, 503 (hereinafter, "*Sutherland*").

[2]26 U.S.C. § 162(a).

[3]*Bingham's Trust v. Commissioner*, [45-2 USTC ¶ 932.7], 325 U.S. 365, 370 (1945).

[4]Rule 142(a); *INDOPCO, Inc. v. Commissioner,* [92-1 USTC ¶ 50, 113], 503 U.S. 79, 84 (1992);

[5]26 U.S.C. § 162(a)(1)

[6]§ 1.162-25T, Temporary Income Tax Regs., 50 Fed. Reg. 747, 755 (Jan. 7, 1985), amended 50 Fed. Reg. 46005, 48013 (Nov. 6, 1985); § 1.61-21(b), Income Tax Regs.

[7]§ 1.162-25T, Temporary Income Tax Regs., *supra.*

[8]See 4. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 402, 423; S. Rept. 1881, 87th Cong. 2d Sess. (1962), 1962-3 C.B. 703, 730-731

[9]See *Harrigan Lumber Co. v. Commissioner*, [Dec. 43, 993], 88 T.C. 1562, 1564-1565 (1987), affd. without published opinion 851 F.2d 362 (11th Cir. 1988)

[10]Emphasis added.

[11]*Sutherland*, Tax Court decision at 4.

[12]*Sutherland*, U.S. Ct. App. 8, [2001-2 USTC ¶ 50, 503], United States Court of Appeals, 8th Circuit, Docket No. 00-2827 (July 3, 2001) affirming *per curiam*.

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