INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
November 30, 1999

Number: **200041001**
Release Date: 10/13/2000

Third Party Contact:
Index (UIL) No.: 274.07-00
CASE MIS No.: TAM-110544-99/CC:DOM:IT&A:B2

District Director

Taxpayer's Name:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

A =
B =
C =
D =
G =
H =
X =
Y =
Z =

ISSUE(S):

Whether expenses incurred by X in connection with the use of Y should be disallowed because they were items with respect to a facility used in connection with an activity of a type generally considered to constitute entertainment, amusement, or recreation under § 274(a)(1)(B) of the Internal Revenue Code. If so, should § 274(e)(4) or § 274(e)(5) apply to except these expenses from the application of § 274(a)(1)(B).

CONCLUSION(S):

The expenses incurred by X in connection with the use of Y should not be disallowed as a deduction under § 274(a)(1)(B) because X's expenses for the use of Y are not items with respect to a facility.

FACTS:

The taxpayer, X, is a family owned corporation engaged in the business of selling and marketing Z. X through its wholly owned subsidiaries acquired the G franchise for Z for areas in three states.

Together A and, his son, B owned substantial stock interests in X during all 3 years to which this request relates. They owned more than 50% of X during a portion of this time period. A was president and chief executive officer during part of this period. B held those positions during the remainder of this period.

A and B state that due to unusual circumstances, the relationship between the employees of X and the employees of its subsidiaries was hostile. Further, the relationship among the subsidiaries themselves was even more strained. There were also severe management problems within X and each subsidiary that were different from the disputes among the companies. Consequently, A and B decided that conferences should begin at Y as part of a continuing effort to break down the walls of animosity which existed within the entire organization. However, in an unrelated prior nontax legal matter, B also testified that X's use of Y for conferences is primarily for incentive trips for customers and employees. Further, B testified in this lawsuit that the employee trips to use Y was for a challenging vacation atmosphere. X claims that these statements were taken out of context of the entire testimony.

Y is located on an island located in H and consists of a tract of land that contains resort style guest rooms and amenities for guests. Y is owned by C. C was owned by A, B, and another family member, D, during the 3 years in question. During these years, Y was used at various times by A, B, D, their friends, and by X for its meetings, and by B in connection with other business interests. Y was not advertised or marketed to the general public.

At various times persons unrelated to X's business used Y while X held meetings at Y. When X used Y, there was a full time cook and a helper who assisted with cooking and housekeeping services. Also, two individuals attended to the grounds and the marina. The outside facilities contained a marina with fishing boats, tennis courts, swimming pool, hot tub, beach cabana, and dive shop. Invitees of X were not permitted to use the outside facilities during times that business meetings were held.

A and B make the following representations about X's use of Y. Business meetings were held each day. Meetings were approximately 3 to 4 hours and typically involved either employee only meetings or meetings between certain strategic employees of X and franchise managers from G or other G franchisees. A or B generally attended the employee meetings. A and B attended the meetings that included the franchise managers from G. The purpose of the meetings would vary depending on the particular group invited. In general, the objective of the meetings is represented to provide a forum to discuss common problems encountered by employees and to work to develop viable solutions. No spouses or other guests of the X employees were invited to Y during these meetings. When X selected its employees to go to these meetings, it became mandatory for them to attend. It is stated that this requirement to attend is no

different than requiring an employee to go on a business trip at the request of his employer. It is represented that X intended to select the most productive and talented employees because they would have the most to contribute to the business meetings by sharing their ideas and approach to problems and to spread their positive attitudes to other participants at the conferences. Employees from three different locations (the three states in which X subsidiaries had a G franchise) attended these meetings. Employee and business associate trips to Y generally did not exceed 1 week. After a daily meeting ended, the participants in these meetings proceeded on to planned recreational activities for the remainder of the day. These activities were typically deep sea fishing and scuba diving. X submitted affidavits from several employees stating that these recreational activities were important in building team work.

C and X did not enter into a written agreement regarding X's payment for the use of Y in any of the three tax years under audit. In 1992, X paid for the use of Y by paying some of the upkeep and repair expenses of the resort directly instead of paying C directly. Whether the expenses paid by X were equal to the fair market value that passed from C to X for the use of Y is not an issue presented here for technical advice. Therefore, for purposes of this technical advice, we assumed C received only fair value for X's use. In 1993 and 1994, X paid for the use of Y by paying A directly, instead of paying C, at a rate on a per diem basis. This payment generally did not include a daily amount for use by stockholders of Y who were also stockholders of X. The amount of the rate charged is not an issue presented here for technical advice, and again, for purposes of this technical advice, we assumed C received only fair value for X's use.

Upon audit several questions were raised concerning § 162, § 274(a)(1)(A), § 274(a)(1)(B) and § 274(e). For purposes of this technical advice, taxpayer requested (with the concurrence of the appeals office) our consideration of the issue whether § 274(a)(1)(B) denies a deduction for the expenses X incurred at Y with respect to a facility used in connection with an activity of a type generally considered to constitute entertainment, amusement or recreation. If § 274(a)(1)(B) does deny the deduction, we are then asked to consider whether the exceptions of 274(e)(4) or (5) apply to except X from § 274(a)(1)(B).

LAW AND ANALYSIS:

Section 274(a)(1)(B) as originally enacted provided that no deduction otherwise allowable shall be allowed with respect to a facility used in connection with an activity referred to in subparagraph (A), unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business.

Section 361 of the Revenue Act of 1978, Pub. L. 95-600, 1978-3 (Vol. 1) C.B. 81 amended § 274(a)(1)(B) to delete the language "unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business." In Senate Committee Report (S. Rep. No. 95-1263, 95th Cong., 2d Sess. (1978), 1978-3 (Vol. 1) C.B. 472), which accompanied the Revenue Act of 1978, Congress recognized that "some legitimate business expenses may be incurred with respect to entertainment

facilities" but determined that "such expenses should be disallowed as business deductions" in order to discourage the "significant opportunities for abuse" presented by entertainment facilities. Similarly, Congress stated that "the bill would not disallow an otherwise, allowable deduction for items relating to bona fide business expenses incurred while away from home overnight. For example, the bill generally would not apply to expenses incurred by an individual away from home at a bona fide business, trade, or professional organization meeting or convention." Id. at 473.

Consequently, effective for items paid or incurred after December 31, 1978, in tax years ending after such date, § 274(a)(1) provides that no deduction otherwise allowable shall be allowed for any item (A) 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 (B) with respect to a facility used in connection with an activity referred to in subparagraph (A).

Section 1.274-2(e)(2)(i) of the Income Tax Regulations provides that any item of personal or real property owned, rented, or used by a taxpayer shall be considered to constitute a facility used in connection with entertainment if it is used during the taxable year for, or in connection with, entertainment. Examples of facilities which might be used for, or in connection with, entertainment include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites, and homes in vacation resorts.

The examples of facilities set forth in the regulations follow the legislative history in S. Rep. No. 95-1263, supra at 473. That report gave examples of "yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments and houses (such as beach cottages and ski lodges) located in recreational areas. However, the deduction is not affected unless the property is used in connection with entertainment."

Section 1.274-2(b)(1)(i) of the Income Tax Regulations provides the definition of entertainment. In general, for purposes of this section, the term "entertainment" means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term "entertainment" may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term "entertainment" does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as a hotel room maintained by an employer for lodging of his employees while in business travel status. On the other hand, 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.

Section 1.274-2(b)(1)(ii) provides, in part, that an objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments such as that "entertainment" means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations.

Section 1.274-2(e)(3)(iii) provides that expenses (exclusive of operating costs and other such expenses referred to in § 1.274-2(e)(3)(i)) incurred at the time of an entertainment activity, even though in connection with the use of facility for entertainment purposes, such as expenses for food and beverages, or expenses for catering, or expenses for gasoline and fishing bait consumed on a fishing trip, shall not be considered to constitute expenditures with respect to a facility used in connection with entertainment.

The first question we must decide is whether (1) Y is a facility and (2) if Y is a facility, then is it used in connection with an activity of a type generally considered to constitute entertainment, amusement, or recreation. Although X does not own Y, decided cases indicate that use of an item of real property such as Y can still be considered an item with respect to a facility used in connection with entertainment so long as X has exclusive use of the property during the taxable year for, or in connection with, entertainment.

In Harrigan Lumber Co. v. Commissioner, 88 TC 1562, (1987), aff'd, 851 F2d 362 (11th Cir. 1988), the taxpayer leased hunting rights on a tract of approximately 6,098 acres for a period of 10 years. The lease states that the officers, employees, and guests of petitioner shall enjoy exclusive hunting rights, except with respect to members of the lessor's family. Lessor's family use was restricted to personal use and may not happen while taxpayer is there nor during the preceding two days. Taxpayer must provide notice to lessor of planned hunts on the property. Taxpayer used the lodge and hunting area principally for commercial purposes, to develop or maintain business relationships with its suppliers and customers. Taxpayer used the lodge and hunting area or both, on thirty separate occasions during the two years in question. Generally, each use was for 1 to 2 days, at which representatives from one and sometimes two companies would attend. Taxpayer engaged in over $5,000,000 worth of business with the companies whose representatives visited taxpayer's hunting lodge. On one occasion taxpayer concluded a verbal agreement with a representative of a customer to which taxpayer sold some products. Taxpayer's principal purpose in entertaining its suppliers and customers was to generate good will and to develop and maintain commercial relationships with the individuals involved. The parties also stipulated that all activities that took place on the hunting area were hunting or fishing.

Based on the legislative history of § 274, the court stated that a material difference between an entertainment activity that includes the use of real or personal property and an entertainment facility is whether the property used for the entertainment is occupied exclusively by the taxpayer for or during the recreation or entertainment. The court

continued that in this case the taxpayer has the exclusive right to use the hunting area for hunting, fishing, and other recreation. The exclusive lease grants to taxpayer on prior notice unfettered access to the hunting area. The hunting area is where the recreation takes place. During taxpayer's recreation in the hunting area, taxpayer has exclusive occupancy of the hunting area. Therefore, the hunting area is a facility used in connection with entertainment within the meaning of § 274(a)(1)(B). In this case, petitioner's payments gave it continuing, unfettered access to the property and exclusive occupancy in order to hunt, fish, and cook out.

In Ireland v. Commissioner, 89 T.C. 978 (1987), petitioners purchased three acres of beachfront property with three buildings on the property. Petitioner, a stockbroker, held various meetings at the property. He met with investment advisors, current and prospective clients, and personnel of the firm he worked for such as salesmen, trainees, and other partners. On occasion, the families of the business associates accompanied them. Petitioners and their family did not take a vacation at the property nor use it as a residence. The court concluded that the property is a facility within the meaning of the statute and that the property was used in connection with an activity that under an objective standard would be considered to constitute entertainment because the outings of individuals accompanied by family members appeared to be vacation trips for the family members. Although the record did not reflect the activities of the family members, the court pointed out that this was three acres of beach front property. Also, the meetings typically lasted several days and there were lodging facilities. The court also held that any use of the facility, no matter how small, in connection with entertainment is fatal to the claimed deduction.

In On Shore Quality Control Specialist v. Commissioner, T.C. Memo 1996-95, petitioner paid rent under an oral lease to hunt on a ranch renewable from hunting season to hunting season. The property included a cabin, and petitioner invited business customers to go hunting on the property. The property was not leased to anyone other than petitioner, although some friends and business acquaintances of lessor could also hunt on the ranch. Before they could hunt, however, they had to notify petitioner first. Generally petitioner included them in his hunting plans. Petitioner argued that the ranch does not constitute a "facility" because the hunting lease did not grant petitioner the "exclusive use" of the ranch. The court had no difficulty in finding that the rent was an operating expense or item with respect to a facility and that, in substance, the taxpayer enjoyed the exclusive rights under the lease. The exclusivity language refers to the right of the lessee to bar the general public, and not a limited number of persons covered by a lease from participating in the recreation. The court concluded that the petitioner dominated the hunting usage of the ranch and that the expenditures for that usage were made for a "facility" used in connection with entertainment by reason of its use for hunting, which generally constitutes recreation.

In United Title Insurance Company v. Commissioner, T.C. Memo 1988-38, petitioner, a real estate title insurance company, sponsored three out-of-state board meetings to resorts at Las Vegas, New Orleans, and Puerto Rico. The trips included the directors of petitioner, real estate attorneys, developers, realtors, bankers, lenders, and spouses or friends. The number of persons on a trip varied from 40 to 93. The trips were 4 days. The first day was for traveling. On the morning of the second day, a board meeting was

held. The participants had the remainder of the second day and the third day at their leisure. Most of the fourth day was for returning home. The facts set forth a number of business reasons for having these meetings and the topics discussed. Based on the record as a whole, the court was satisfied that board meetings were held and that substantial corporate business was conducted during each of the trips. The court held that the trip expenses attributable to petitioner's directors, officers, and real estate guests were directly related to the active conduct of petitioner's business. See § 274(a)(1)(a). The court did not examine this case in the context of whether the resorts were "facilities" under § 274(a)(1)(B) apparently, in part, because the large, independent resorts involved were not intended to be the kind of property to be included within the meaning of the term "facility". Also, payments for hotel accommodations for employees on business travel, even if maintained by taxpayer (though these were not) would not be for use of a facility.

In Mcreavy v. Commissioner, T.C. Memo 1989-172 (1989), the taxpayer relied unsuccessfully on § 274(e)(5) (now § 274(e)(4)) as an exception to the argument that § 274(a)(1)(B) should apply to disallow expenses of a lake cabin because the property was a facility used in connection with entertainment. Section 274(a)(1)(B) applied in Mcreavy because use generally by employees was not shown; rather, the taxpayer, who was the sole shareholder of the corporation that owned the lake cabin property, essentially used the lake cabin property entirely as if it was his own for recreational purposes.

Applying these principles to the facts here, it appears that X arranged face to face meetings among employees that could not be held without employee travel to some location because these employees were located in more than one state. Employee attendance was mandatory once selected. X arranged for these meeting to be held at Y, although no lease or other documentation covered X's use of Y. X appears to have paid C only for overnight lodging for X's employees and business associates who it believed were at Y attending formal business meetings followed by recreational activities.

The absence of a written lease and the stockholdings of A and B in both X and Y make it difficult to determine the precise character of X's use of Y. Y was used by its stockholders when not used by X. It also appears that X did not have exclusive use of Y because at various times guests unrelated to X used Y simultaneously with X. It thus does not appear that the use of Y by its stockholders and other guests is part of X's arrangement for the use of Y. Nor from this record can we conclude that X otherwise dominates the use of Y. In this regard, the use of Y by other persons when X conducted meetings there does not resemble the hunting use of the property in On Shore that was provided for in the lease and that allowed On Shore to dominate the hunting use. The form of X's payments, to the extent made only for the use of Y on specific occasions in connection with X's intention to hold formal business meetings, is consistent with this view, and suggests that X's payments did not compensate Y for any operating expenses connected with providing continuing or future use by X of Y.

The facts of Harrigan v. Lumber Co., On Shore Quality Control Specialist, Ireland, and Mcreavy all differ from this case because they involve ownership or long term leases

providing exclusive or dominant use of the facility. For example, in On Shore, the taxpayer exercised so much control over the Lessor's use of the property, that the court had no difficulty in treating taxpayer's dominant use as exclusive use. Here, payment is made for short term nonexclusive use in connection with overnight lodging in a manner more similar to payments made in United Title.

In our view, the facts do not demonstrate that X dominated the use of Y, so we can not consider its use to be like the exclusive use contemplated in § 274(a)(1)(B).

Accordingly, §274(a)(1)(B) does not disallow expenses incurred by X in connection with the use of Y because X's payments for its use of Y are not items with respect to a facility as contemplated by that section. Therefore, we do not need to address the questions of whether a facility was used in connection with an activity of a type generally considered to constitute entertainment, amusement, or recreation or whether an exception under § 274(e) applies to the application of § 274(a).

CAVEAT(S):

No opinion is expressed whether the expenses X paid for the use of Y are deductible as ordinary and necessary expenses within the meaning of § 162 or whether any portion of the expenses is an entertainment expense subject to disallowance under any other provision in § 274(a).

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.