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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Area Counsel SBSE
Thousand Oaks
CC:SB/SE:8
Attn: Steven M. Roth

FROM: Associate Chief Counsel
Income Tax & Accounting

SUBJECT: Amount deductible for use of private plane

This Field Service Advice responds to your memorandum dated February 8, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Mr. X	=
Professional Y	=
Corp A	=
Corp B	=
Trust C	=
d years	=
Type E companies	=
Tax Year 1	=

ISSUE

Whether Corp B is entitled to deduct, as part of travel expenses for Mr. X, payments to Corp A measured by the cost of travel by private charter or should the deductions be limited to the cost of first class travel.

CONCLUSION

If Corp B's payments to Corp A for air travel for Mr. X are found not to be reasonable, the amount of deduction allowable should be limited to the cost of first class travel rather than the cost of private charter.

FACTS

Mr. X is a very successful Professional Y and is sometimes required to travel away from home on business. For a number of tax years, Mr. X has claimed substantial losses attributable to Corp A, a Subchapter S corporation, on his individual federal income tax return. Corp A has been identified as an "airplane charter." Until several years prior to the tax year at issue, Mr. X was the 100% shareholder of Corp A. Since that date, Trust C, which apparently is Mr. X's grantor trust, has been the100% owner of Corp A. Trust C also owns Corp B, a Subchapter C corporation, which is Mr. X's personal service corporation.

Corp A owns several airplanes. They are not available for lease to the general public. Corp A does not have a FAA (Federal Aviation Agency) Part 135 license, which is apparently necessary to hold out the airplanes for lease to the general public. Instead, the airplanes are almost exclusively used by Mr. X and his family. The only income earned by Corp A comes from Corp B. Corp B negotiates contracts for Mr. X's services with Type E companies and arranges for Mr. X's travel. Mr. X uses the aircraft owned by Corp A to fly to business locations. Sometimes specific amounts are negotiated to pay for the cost of Mr. X's travel with the companies that employ him. Mr. X, who is a pilot, also uses the airplanes for personal reasons. The amounts attributable to Mr. X's personal use of the airplanes are not deducted by Corp A.

Corp A has never shown a profit and has instead sustained losses each year for at least d years. There is evidence that the amounts paid from Corp B to Corp A for use of the airplanes is less than their fair rental value. To make up for shortfalls in prior years, Mr. X has deposited amounts in Corp A's bank accounts.

Mr. X asserts that he needed to fly by private charter to meet his business commitments and, further, that owning his own airplane was superior to hiring a private charter company. Convenience, cost and safety were the reasons given.

Mr. X argues that it was more convenient to fly by private charter because he was often in remote locations, and there were no private charter companies in the vicinity. Although his schedule was often known well in advance for certain events, others would come up on short notice, and commercial flights, with their delays and lack of connections were far too inconvenient. Private charters also allowed him to work while on the airplane without the distractions of public intrusions.

Mr. X argued that it could be actually more costly to hire a private charter than to use his own plane. He gave two examples. First, when there are no private charter companies in the vicinity, Mr. X would have to pay for the flight to bring the plane to him, and then for the return on the airplane to the home city. Second, if Mr. X had an appointment in a distant city and used a private charter, he would need to choose to either pay the charter company for the airplane to wait for him, or send the airplane

back to its originating city. The cost of the flight and the waiting time would likely exceed the amount paid by Corp B to Corp A, because Corp B paid only for flight time. Mr. X also believes it is safer for him to fly by private charter because of his celebrity status.

The tax year currently at issue is Tax Year 1.

LAW AND ANALYSIS

I.R.C. § 162(a)(2) generally allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

Under Treas. Reg. § 1.162-2(a), only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted.

A question has previously arisen whether Corp A's activity is engaged in for profit within the meaning of section 183. Section 183(a) provides that if an individual or an S corporation is engaged in an activity that is not engaged in for profit, no deduction attributable to the activity shall be allowed except as provided in that section. Section 183(c) defines an activity not engaged in for profit as any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under section 212(1) or (2). Deductions are allowable under section 162 or under section 212(1) or (2) only where the taxpayer is engaged in an activity with an actual and honest objective of making a profit. Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), aff'd 702 F.2d 1205 (D.C. Cir. 1983); Allen v. Commissioner, 72 T.C. 28 (1979), acq. 1979-1 C.B. 1.

We provided advice for earlier tax years that the activity of Corp A could not be aggregated with the activity of Corp B for the purposes of Treas. Reg. § 1.183-1(d)(1). As a result, in the determination of whether Corp A's activity is engaged in for profit, the pattern of losses incurred by Corp A cannot be offset by net income generated by Corp B. Corp A and Corp B are instead to be treated as two separate taxable entities. See Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Deputy v. du Pont, 308 U.S. 488 (1940). See also AOD, CC-193-001, written as a result of the decision in Campbell v Commissioner, 868 F.2d 833 (6th Cir. 1989), nonacq., 1993-1 C.B. 1, 1993-2 C.B. 1, which dealt with a similar issue.

Consistent with this conclusion, Corp B's deduction of payments should be considered separately from any conclusion that Corp A's activity is not engaged in for profit. The underlying issue here is whether Corp B's payments to Corp A for air travel are ordinary and necessary business expenses under section 162(a). Of particular

concern is whether they are reasonable in amount, which is required for them to be ordinary and necessary . See Treas. Reg. § 1.162-2(a). See also Noyce v. Commissioner, 97 T.C. 670, 687-88 (1991), which dealt with the deduction of the costs of a private plane. If the payments are ordinary and necessary, Corp B may deduct them in full. If they are not reasonable and, for that reason alone not ordinary and necessary, Corp B may only deduct the cost of first class airfare. Kurzet v. Commissioner, T.C. Memo. 1997-54, 73 TCM (CCH) 1867, aff'd in part and rev'd in part, 222 F.3d 830 (10th Cir. 2000).

In Kurzet, the taxpayers were claiming the costs of a personally-owned Lear jet as ordinary and necessary expenses of a timber farm, a consulting business, or of a computer and real estate rental business. The potential business use of the jet was narrowed by the Tax Court to flights to a timber farm in Oregon and to condominiums in Park City, Utah. The court found that the expenses of purchasing, maintaining and operating a personal Lear jet to make a few trips each year to Oregon and Utah, were extraordinary. Instead, "the large transportation expenses (including significant noncash expenses such as depreciation) associated with the Lear jet appear to be out of the ordinary and to be unnecessary. " 73 TCM (CCH) at 1881. Further, the court regarded the inconvenience the taxpayers would have experienced flying to their timber farm in Oregon "as minimal, as ordinary and as common, both for individuals and for businessmen," especially because the timber farm was not currently earning income. Id. The travel to Park City on the Lear jet was rejected as either extravagant or personal as relating to the taxpayer's skiing and personal residence there. The court allowed the otherwise ordinary and necessary travel to the timber farm based on first class air fare.

The Tenth Circuit reversed the Tax Court's disallowance of the cost of the Lear jet to fly to the Oregon property but did not criticize the Tax Court's allowance of first class airfare in lieu of a showing that the expenses attributable to an alternative means of travel by air were reasonable. The Tenth Circuit agreed with the parties that the Tax Court had disallowed the cost of flights on the Lear jet to the Oregon farm because they were unreasonable and found that the Tax Court holding as to this factual matter was clearly erroneous. 222 F.3d at 834-35. First, the Tax Court should not have considered the depreciation of the airplane when determining whether the expenses of the plane were unreasonable. 222 F.3d at 835-836, citing Noyce, 97 T.C. at 687. Second, the Tax Court had underestimated the number of trips the taxpayers had taken to Oregon by at least half. 222 F.3d at 836. Lastly, and most significant to the present case, the Tenth Circuit found that the Tax Court did not give sufficient weight to the time savings associated with use of the Lear jet. 222 F.3d at 836. The Tenth Circuit took the number of hours saved by flying by personal Lear jet during each year, multiplied it by the value of Mr. Kurzet's time on an hourly basis and added the result to the cost of first class travel. 222 F.3d at 837. The Tenth Circuit then compared this sum with the expenses deducted for the Lear jet and found that the actual costs of the Lear jet for the trips to Oregon were reasonable. 222 F.3d at 837. Thus, the Tenth Circuit retained the reliance on first class airfare as a standard for reasonableness in

determining ordinary and necessary travel expenses. The fair market value of a taxpayer's time, which the Tenth Circuit added to the first class travel for the purposes of comparison, would not be deductible.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted] we agree with you that Noyce, set forth important standards for when costs for using an airplane can be an ordinary and necessary business expense. In conclusion, it may well be that the payments made by Corp B to Corp A for Mr. X's business travel are reasonable and thus ordinary and necessary. [redacted] However, this would not affect the conclusion that Corp A is not an activity engaged in for profit.

Please call Grace Matuszeski at (202) 622-7900, with any comments or questions.

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