Office of Chief Counsel
Internal Revenue Service

memorandum

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JEKagy

date:

to: Chief, Examination Division, Ohio District
Attn: Rick Ollendick

from: Assistant District Counsel, Ohio District, Cincinnati

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subject: [redacted]
Comparison of the *Sutherland Lumber* and *Gow* Opinions

DISCLOSURE STATEMENT

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This memorandum responds to your April 3, 2000 inquiry regarding a reconciliation of the two recent Tax Court opinions referenced above. In particular, you asked whether we believed that the combination of the two cases permitted the Service to disallow the claimed corporate expenses associated with the [redacted] personal travel on corporate jets under the theory that the expenses are dividends which are nondeductible to the corporation.

ISSUE:

Whether the aircraft expenses associated with executives' personal travel on corporate jets may be considered nondeductible dividends to the employer corporation in instances where the value of the vacation use of the aircraft has been calculated and reported as imputed income to the executives consistent with Treas. Reg. § 1.61-21(g).

CONCLUSION:

If the value of a noncash fringe benefit has been included in the recipient employee's gross income, the employer may take a deduction for expenses incurred in providing the benefit. Temp. Treas. Reg. § 1.162-25T. So long as the vacation use of the aircraft has been calculated and reported as imputed income to the executives consistent with Treas. Reg. § 1.61-21(g), the "value" of the benefit has already been taxed, and the employer is entitled to the deduction. Nevertheless, pending final appeal of, or the Service's acquiescence in, *Sutherland Lumber*, the amount of the employer's deduction is limited to the amount of the compensation imputed to the executives.

ANALYSIS:

In its opinion in *Sutherland Lumber v. Commissioner*, 114 T.C. No. 14 (March 28, 2000), the Tax Court concluded an employer may deduct the full cost of providing corporate owned aircraft for its executives' vacation flights. The Service's position is that the amount of expenses deductible to the employer is limited to the income reported as a noncash fringe benefit to the corporate executives.

In *Gow v. Commissioner*, T.C. Memo. 2000-93, the Tax Court held that an employer's reimbursement of its corporate executives' travel and entertainment expenses for trips to Hawaii and Key West constituted constructive dividends to the executives.

The agents questioned whether the expenses associated with the employer providing corporate owned aircraft for its executive's vacation flights (as in *Sutherland*) could also be viewed as nondeductible dividends to the employer. In other words, can the opinion in *Gow* be used to preclude the expensing of the costs associated with vacation flights of the corporate executives? For the reasons set forth below, we do not believe *Gow* can be used for the purpose you suggest.

Section 162(a) generally provides that a taxpayer is allowed a deduction for all ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business. An expenditure is "ordinary and necessary" if the taxpayer establishes that it is directly connected with, or proximately related to, the taxpayer's activities. See *Bingham's Trust v. Commissioner, 325 U.S. 365, 370 (1945).*

A taxpayer/employer may deduct an expense, paid as compensation for personal services, as an ordinary expense of carrying on a trade or business. Section 162(a)(1). If the compensation is paid in the form of noncash fringe benefits, an employer may take a deduction for expenses incurred in providing the benefit if the value of the noncash fringe benefit is included in the recipient employee's gross income. *Temp. Treas. Reg. § 1.162-25T. See also* Treas. Reg. § 1.61-21(b) (employee is required to include in gross income the value of any fringe benefit received). 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. *See* Temp. Treas. Reg. § 1.162-25T.

Generally, for purposes of imputing employee fringe benefit income, the value of a benefit received from use of corporate property is the fair rental value of such property, less any reimbursement. *Ireland v. United States*, 621 F.2d 731, 737-39 (5th Cir. 1980). For reasons not germane here, Congress has provided specific valuation rates for certain benefits, including flights by employees on noncommercial aircraft, for purposes of computing the amount of taxable income to the recipients. While the rate (referred to as the "Standard Industry Fare Level" or "SIFL") is derived from commercial airline rates, the rate bears no connection to the actual costs incurred by a corporation to operate its aircraft. Nevertheless, by permitting the use of SIFL as the measuring yardstick, the Service is bound to accept its use as reflecting the value of the noncommercial flight.

Certainly, when a corporation makes an expenditure or distribution out of its earnings and profits (without an expectation of repayment) primarily to confer a substantial personal benefit to a shareholder, the value of the benefit conferred is taxable as a constructive dividend. *See Ireland v. United States*, 621 F.2d 731, 735 (5th Cir. 1980); *Falsetti v. Commissioner*, 85 T.C. 332, 356-357 (1985). Dividends are not deductible.

Whether a particular economic benefit constitutes a constructive dividend is a question of fact. *Loftin and Woodward, Inc. v. United States*, 577 F.2d 1206 (5th Cir. 1978). Without considering whether the facts you have developed can be construed to constitute a constructive dividend, we believe the Treasury regulations promulgated regarding fringe benefits control your situation.

A distinction exists, although perhaps small, between a corporation which pays for or reimburses an executive's vacation costs (i.e., a dividend), and a corporation which puts a corporate aircraft at the disposal of the executive, but charges a Service approved value to the executive for the noncash fringe benefit. The distinction is simply whether the fact situation presents a situation which is addressed and controlled by the fringe benefits regulations.

The facts in *Gow* did not include the use of a corporate owned or leased aircraft or any other noncash fringe benefit. The opinion in *Gow* addressed an instance outside the parameters of the fringe benefits regulations. Because your facts include corporate fringe benefits, the *Gow* opinion would not be applicable to your situation.

In the instance of noncash fringe benefits, Treasury regulations dictate not only that the corporate executive must recognize gross income equal to the calculated value of the air travel pursuant to Treas. Reg. § 1.61-21(g), but that also 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.

As long as the employer and employee operate within the guidelines of the fringe benefit rules and regulations, those regulations provide the treatment to both parties. We believe that the clear and unequivocal language of Temp. Treas. Reg. § 1.162-25T controls your fact pattern. In a situation where the fringe benefits regulations apply, if the value of a noncash fringe benefit has been included in the recipient employee's gross income, the employer may take a deduction for expenses incurred in providing the benefit. Temp. Treas. Reg. § 1.162-25T.

Here, the value of the noncash fringe benefit, computed as required under Treas. Reg. § 1.61, has been included in the income of the executives. Temp. Treas. Reg. § 1.162-25T mandates that the employer may take a deduction for expenses incurred in providing the benefit. The only question which remains in your fact pattern is the size of the deduction permitted to the

employer corporation, a question which will be resolved with the appeal of *Sutherland Lumber*.

Please contact the undersigned if any additional questions exist.

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