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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224-----

CC-2002-02
Feb 11, 2002
Attachment 1

ACTION ON DECISION

SUBJECT: Sutherland Lumber-Southwest, Inc. v. Commissioner
255 F.3d 495 (8th Cir. 2001)

Issue:

Whether a taxpayer that provides vacation flights to employees and includes the value of the flights in the employees' income using the SIFL rates of Treas. Reg. § 1.61-21(g) may then deduct the full (higher) cost of providing the flights, notwithstanding the deduction disallowance provisions of I.R.C. § 274(a).

Discussion:

The taxpayer, Sutherland, used a corporate aircraft primarily in connection with business travel described in § 162(a)(2). In addition, employees sometimes used the corporate aircraft for vacation flights. Sutherland calculated and reported the amount of imputed income for the employees' vacation flights according to Standard Industry Fare Level (SIFL) rates found in Reg. § 1.61-21(g). Although these valuations were significantly less than the cost of providing the vacation flights, Sutherland deducted the full cost of the flights. The Service disallowed Sutherland's deductions for the amount of the expenses for the vacation flights that exceeded the amount Sutherland treated as compensation and as wages to the employees.

At issue was the scope of the section 274(e)(2) exception to the general disallowance rules of section 274(a). Section 274(a) denies deductions for otherwise allowable expenditures incurred in providing entertainment not sufficiently related to a taxpayer's trade or business. Section 274(e)(2) excepts from the disallowance deductions for such expenses "to the extent that the expenses are treated by the taxpayer" as compensation and wages to the employee. The Service contended that the section 274(e)(2) exception applied only to the amount treated as compensation and wages and that section 274(a) therefore disallowed any deduction for the portion of the expenses exceeding the amount treated as wages and compensation.

The Tax Court, however, held that the disallowance provisions of section 274(a) were inapplicable because "section 274(e) was intended to except certain categories of deduction from the effect of section 274." 114 T.C. 197, 203 (2000) [emphasis added].

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Thus, the court concluded that “section 274(e)(2) acts to except the deductions in controversy from the effect of section 274, and, accordingly, [Sutherland’s] deduction [was] not limited to the value reportable by its employees.” 114 T.C. at 206. On appeal, the United States Court of Appeals for the Eighth Circuit affirmed.

The Service will no longer litigate this issue in cases in which a taxpayer demonstrates that it has properly included in compensation and wages the value of an employee vacation flight in accordance with Treas. Reg. § 1.61-21(g). In those cases, the Service will allow the taxpayer a full deduction for the cost of the flight. The Service will continue to apply § 274(a) to cases in which the value of an employee vacation flight is not included in compensation and wages.

Recommendation:

Acquiescence.

Reviewers:

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