INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 13, 2001

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Index (UIL) No.: 274.01-00, 274.07-00
CASE MIS No.: TAM-142791-01/CC:ITA:B07

Chief, Planning and Special Programs, Area 11

Taxpayer's Name: .
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference: (***No Conference Held***)

LEGEND:

A=
B=
Facility=
Taxpayer=
Fees=
Q=
X=
Year1=
Year2=
Year3=
Year4=

ISSUE:

Whether expenses incurred by Taxpayer in operation of a recreation facility are disallowed under § 274(a)(1) of the Internal Revenue Code when the facility is used primarily by and for the benefit of another S corporation and most of the stock of Taxpayer and the S corporation are owned by a husband and wife.

CONCLUSION:

Even with substantial common ownership and even though the S corporation's employees and clients use the recreational facility (for which S corporation pays the

Taxpayer), Taxpayer and the S corporation are properly viewed as separate taxpayers so that § 274(a)(1) does not prevent Taxpayer from deducting expenses incurred in the operation of its facility.

FACTS:

A and his wife own all or almost all of several S corporations. Taxpayer is one of the S corporations. Taxpayer was incorporated in Year1 with A and his wife as the sole shareholders. Taxpayer's sole purpose was to develop and operate Facility. The Facility is used primary by B and B's clients. B is an S Corporation owned almost entirely by A and his wife.

Taxpayer's Facility was fully constructed by Year2. The Facility is not open to the general public. Instead, the Facility, which is full service including operation of Q and X, is used for charity events, a few tournaments, and by B's employees and clients. B pays Taxpayer for the cost of hosting charitable events, and individuals pay the charities a fee for participating in charitable events. B pays Fees to Taxpayer when B's employees and clients use the Facility. B deducts the Fees paid to Taxpayer as ordinary and necessary business expenses subject to the 50% limitation for recreation activity under § 274(n)(1)(B). Additionally, the Facility was used by A on occasion and A's wife once a week.

Taxpayer operated at a loss in Year2 and Year3, but operated profitably in Year4 and two subsequent years. Only Year2, Year3 and Year 4 are the subject of this Technical Advice.

The Service argues that because Taxpayer and B are both S corporations owned by A and his wife, and because Taxpayer's Facility is used primarily by B, Taxpayer should be denied deductions due to § 274(a)(1)(B) of the Internal Revenue Code and the regulations. The Service questions whether the transactions between B and the Taxpayer are bona fide transactions. The Service states that the Taxpayer and the other wholly owned S corporations (other than B) exist solely to support B and that they are controlled by B. The Service does not, however, contest Taxpayer's expenses that would validly constitute "out of pocket expenses" allowable under § 1.274-2(e)(3)(iii) of the Income Tax Regulations.

Taxpayer argues that it does not operate Facility for its own recreation or entertainment and, thus, § 274(a)(1)(A) does not apply to it. Taxpayer points out that it operates its Facility for profit.

This Technical Advice will only address the issue as it affects Taxpayer and will not discuss the possible tax ramifications to B.

LAW AND ANALYSIS:

LAW:

Section 162(a) of the Internal Revenue Code provides generally that a taxpayer may deduct 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 it is directly connected with, or proximately related to, the taxpayer's trade or business activities.

Section 274(a)(1)(A) of the Internal Revenue Code provides that no deduction otherwise allowable under § 162 will be allowed with respect to entertainment, amusement, or recreation ACTIVITY unless the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business. Section 274(a)(1)(B) disallows any § 162 deduction for items with respect to a FACILITY used in connection with entertainment, amusement or recreation.

Section 1.274-2(e)(2)(i) of the Income Tax Regulations, which defines facility, 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 (as defined in paragraph (b)(1) of this section). 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.

Facilities may also include airplanes, automobiles, hotel suites, apartments and houses (such as beach cottages and ski lodges) located in recreational areas. *See* S. Rep. No. 95-1263, 95th Cong., 2d Sess. (1978), 1978-3 (Vol. 1) C.B. 473.

However, a deduction will not be affected unless the property is used in connection with entertainment. Any use, no matter how small, for entertainment is fatal to the claimed deduction. *See Ireland v. Commissioner,* 89 T.C. 978 (1987).

Section 1.274-2(b)(1)(i) of the Income Tax Regulations, which defines entertainment, provides that:

> 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) supper money provided by an employer to his employee working overtime, (b) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (c) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. 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.

The Code recognizes, however, that there are taxpayers in the business of entertainment and that it would be unfair to deny deductions for operating such establishments. Specifically, § 274(e)(8) of the Internal Revenue Code provides that, even though a facility might fall within the definition of an "entertainment facility," the limitations of subsection (a) of § 274 do not apply to "[e]xpenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth." Similarly, § 1.274-2(f)(2)(ix) provides that:

> Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) to the extent the entertainment is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Thus, the cost of producing night club entertainment (such as salaries paid to employees of night clubs and amounts paid to performers) for sale to customers or the cost of operating a pleasure cruise ship as a business will come within this exception.

Despite the fact that a facility might fit the definition of an "entertainment facility," expenses relating to its operation will not constitute "entertainment" expenses if that facility is legitimately involved in selling entertainment. H.R. Rep. No. 1447, 87th Cong., 2d Sess. 25 (1962), 1962-3 C.B. at 429, and S. Rep. No. 1881, 87th Cong., 2d Sess. 37 (1962), 1962-3 C.B. at 743.

Additionally, § 1.274-2(e)(3)(iii) of the Income Tax Regulations 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.

Generally, the tax law will recognize the existence of separate entities. *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); *Deputy v. duPont*, 308 U.S. 488 (1940); *Durando v. United States*, 70 F.3d 548, 551-52 n.9 (9th Cir. 1995); *see Crook v.*

Commissioner, 80 T.C. 27, 32 (1983), *affd*. without published opinion 747 F.2d 1463 (5th Cir. 1984). In *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), the corporate taxpayer sought to have the gain on the sale of its real property treated as the gain of its sole shareholder and its corporate existence ignored as merely fictitious. The Court concluded that the corporation had a tax identity distinct from its sole shareholder. The Court noted that whether the purpose of a corporate entity is to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors, or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of a business by the corporation, the corporation remains a separate taxable entity. (citations omitted). The Court reasoned that in general, in matters relating to the revenue, the corporate form may only be disregarded where it is a sham or unreal.

In *Catalano v. Commissioner*, 240 F.3d 842 (9th Cir. 2001), the taxpayer was the sole shareholder of an S corporation. Taxpayer leased three boats to his S corporation. The corporation deducted the lease payments on its federal corporate income tax returns, and the deductions reduced the corporate income that was passed through to the taxpayer. The taxpayer reported the rental payments as income. The Tax Court found that the boats constituted entertainment facilities, and denied the deductions to the corporation under § 274(a)(1)(B). The taxpayer argued that the disallowance of the corporate-level deduction should result in an offsetting adjustment to his individual income because the individual taxpayer and the S corporation are really a single taxpayer for tax purposes. The court disallowed the offsetting adjustments to the taxpayer's income based on the fundamental principal that an S corporation is a separate entity from its shareholders.

ANALYSIS:

In this case, the Taxpayer owns and operates a Facility. Facility is clearly the type of property that normally would be considered an entertainment or recreational facility. Taxpayer, however, receives revenue from operation of the Facility from several sources. It receives revenue from the operation of its Q & X located on the Facility; from the fees paid by B to host charitable events; and from Fees primarily charged B for use of the Facility itself. The Taxpayer operated at a loss in Year2 and Year3, but operated at a profit in Year4 and the two following years.

As noted earlier, B and Taxpayer are both S corporations owned almost exclusively by A and his wife. There are no facts indicating that Taxpayer is a sham entity. Despite the common ownership of Taxpayer and B, it would not be appropriate to disregard their separate corporate existence. *See Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943). Taxpayer should be viewed separately from B and its shareholders. *Deputy v. duPont*, 308 U.S. 488 (1940); *Durando v. United States*, 70 F.3d 548, 551-52 n.9 (9th Cir. 1995); *Catalano v. Commissioner*, 240 F. 3d 842 (9th Cir. 2001); *see Crook v. Commissioner*, 80 T.C. 27, 32 (1983), *affd*. without published opinion 747 F. 2d 1463

(5th Cir. 1984). Because Taxpayer is properly viewed separately from B, the fact that Taxpayer's Facility is used primarily by employees and clients of B, at B's expense, does not prevent Taxpayer from deducting its operating expenses that would otherwise be allowable under § 162.

CAVEAT(S)

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

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Please call (202) 622-4970 if you have any further questions.