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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, THOUSAND OAKS
CC:WR:LAD:THO

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Aggregation of Airplane Leasing

This Field Service Advice responds to your memorandum, dated November 23, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Mr. X (or taxpayer) =
Professional Y =
Tax Year 1 =
Tax Year 2 =
Tax Year 3 =
Corp A = .
Corp B =
Trust C =
d years =

ISSUES:

1) Whether the activity of Corp A, a Subchapter S corporation, may be aggregated with Corp B, a Subchapter C corporation, under the aggregation rules of Treas. Reg. § 1.183-1(d)(1) for the purposes of determining the profit motive of the S corporation under I.R.C. § 183.

2) Whether Corp B may reclassify disallowed personal expenses of Mr. X as his deductible compensation.

CONCLUSIONS:

1) The activity of Corp A, an S corporation, may not be aggregated with Corp B, a C corporation, under the aggregation rules of Treas. Reg. § 1.183-1(d)(1) for the purposes of determining the profit motive of the S corporation under section 183.

2) Corp B may not reclassify disallowed personal expenses of Mr. X as his deductible compensation.

FACTS:

Mr. X is a very successful Professional Y and is sometimes required to travel away from home on business. For Tax Years 1, 2 and 3, Mr. X, claimed substantial losses attributable to Corp A, an 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 years at issue, Mr. X was the 100% shareholder of Corp A. Since that date, Trust C, which we assume is Mr. X's grantor trust, has been the100% owner of Corp A. Trust C also owns Corp B, a C corporation, which is Mr. X's personal service corporation. Corp A has never shown a profit and has instead sustained losses each year for at least d years.

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 planes are almost exclusively used by Mr. X and his family. The only income earned by Corp A comes from Corp B. Corp B contracts with other entities for Mr. X's services and Mr. X sometimes uses the aircraft owned by Corp A to fly to business locations. Mr. X is a pilot himself and also uses the airplanes for personal reasons. Some allocation has been made for personal use of the airplanes on Corp A's books.

The contract between Corp B and Mr. X contains a clause which attempts to recharacterize certain deductions claimed at the C corporation level. In essence, the clause provides that, if a deduction is disallowed by the Internal Revenue Service, then the amount of that deduction will be recharacterized as compensation to Mr. X. The IRS agent disallowed certain expenditures for wardrobe, entertainment and gifts paid for and deducted by Corp B.

LAW AND ANALYSIS

ISSUE 1

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.

Section 183(d), as it applies to the present case, provides that an activity will be presumed to be an activity engaged in for profit if income exceeds deductions in 3 out of 5 consecutive taxable years.

Treas. Reg. § 1.183-2(b) lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed include: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) the involvement of elements of personal pleasure or recreation.

Treas. Reg. § 1.183-1(d)(1) states that, in order to determine whether, and to what extent, section 183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute an activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that its characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case.

Treas. Reg. § 1.183-1(a) states that no inference is to be drawn from the provision of section 183 and the regulations thereunder that any activity of a corporation (other than an electing small business corporation) is or is not a business or engaged in for profit.

The losses sustained by Corp A should be analyzed under the factors listed in Treas. Reg. § 1.183-2(b). The taxpayer wishes to aggregate the activity of an S corporation with the activity of a C corporation, arguing that the two are under common ownership and management. If the two entities could be aggregated under section 183, the yearly losses generated by Corp A would be combined with the profits shown by Corp B. As a result, Corp A would apparently not have a history of yearly losses as referenced by Treas. Reg. § 1.183-2(b)(6) and would instead meet the presumption found in section 183(d).

By its terms, section 183(a) only applies to individuals and S corporations. Treas. Reg. § 1.183-1(a) extends the application of section 183 to trusts and estates because they are taxed as individuals. Similarly, Rev. Rul. 77-320, 1977-2 C.B. 78, holds that partnerships are subject to section 183 because, under section 703(a), the taxable income of a partner is computed in the same manner as an individual. In contrast, Treas. Reg. § 1.183-1(a) explicitly excludes C corporations from analysis under section 183. By attempting to aggregate a C corporation with an S corporation, taxpayer is attempting to pull a C Corporation into the purview of section 183 in violation of the regulations.

The taxpayer relies upon Campbell v Commissioner, 868 F.2d 833 (6th Cir. 1989), nonacq., 1993-1 C.B. 1, 1993-2 C.B. 1, where the Sixth Circuit reversed the Tax Court's holding that a partnership did not have the requisite profit motive. Similar to the present case, the activity of the partnership was the rental of an airplane which was rented primarily to a related C corporation. In Campbell, the partnership was owned by the shareholders of the C corporation. Campbell is not controlling in the current case.

The Tax Court in Campbell relied in part on the close relationship of the partnership and a C Corporation to find the leasing activity was not engaged in for profit. T.C. Memo. 1986-569. The court noted that the primary purpose of the acquisition of the plane was to provide transportation to the corporation's officers and employees and found that this was clearly not a business purpose of the partnership. Instead, the court found that the partnership was formed solely as a tax avoidance vehicle for the partners who were stockholders of the corporation.

The Sixth Circuit found that the Tax Court erred in its reliance on the close relationship between the corporation and the partnership in finding the lack of profit motive. Instead, the court found that an individual may arrange his affairs to make a profit in a corporation. Specifically, each partner although not profiting from the use of the plane, benefitted through dividends and a very large increase in stock value at the time of the sale of the company. Thus, the entire economic relationship and its consequences were examined by the Sixth Circuit to determine the profit motive of the partnership. However, Campbell does not address whether the undertakings of the C corporation and the partnership were the same activity within the meaning of the regulations.

The Service disagreed with the Sixth Circuit's opinion in its published AOD, CC-193-001, noting that there is no support for the rule that a profit motive may be found in the leasing activity based upon the rationale that the losses generated by that activity would increase the partners' profits as shareholders. The AOD finds that the Sixth Circuit holding that attributes profit motive from the corporation and its shareholders to the partnership violated the "separate taxable entity" concept established by the Supreme Court in Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943) and Deputy v. du Pont, 308 U.S. 488 (1940).

The Tax Court has found Campbell irrelevant to the determination of whether two undertakings may be grouped as a single activity under the regulations. See Wilkinson v. Commissioner, T.C. Memo. 1996-39; De Mendoza v. Commissioner, T.C. Memo. 1994-314. The court found that the issue in Campbell and Kuhn v. Commissioner, T.C. Memo. 1992-460, another case relied upon by the taxpayer, was instead whether a profit objective could exist for an undertaking that derived its income from a related corporation. De Mendoza. See Wilkinson.

Consistent with the discussion above, we do not believe that undertakings conducted separately by two different taxpayers can be combined as a single activity under the regulations. Thus, Rev. Rul. 78-22, 1978-1 C.B. 72, held that a partnership and individual, both involved in horse racing, conducted separate activities under the following facts. The individual taxpayer engaged in horse racing in year 1 as a sole proprietor. In year 2, the individual contributed his race horses to a partnership, in which he became a partner. Horse racing was the partnership's only undertaking. In year 3, the taxpayer acquired other horses and resumed the activity of racing horses as a sole proprietor.

Rev. Rul. 78-22 concluded that "because section 183 of the Code must be applied at the partnership level with respect to activities engaged in by a partnership and at the individual level with respect to activities engaged in by a sole proprietor, the taxpayer's activity of racing horses as a sole proprietor and the activity of the partnership racing horses are two separate activities." 1978-1 C.B. at 72. As a result, the taxpayer's undertaking in year 3 could not be combined with the partnership's undertaking in year 3 as a single activity under Treas. Reg. § 1.183-1(d)(1).

Further, while arguing that the independent taxable entities should be ignored for purposes of the aggregation rules of section 183, taxpayer is attempting to retain the benefits of the two different entities. That is, the losses from the S corporation are flowing through to Mr. X's individual return, while, if they were in fact combined with the undertaking of the C corporation and became part of its business, they could not flow through to him.

For these reasons, we believe that the activities of Corp A and Corp B cannot be combined as one activity under Treas. Reg. § 1.183-1(d)(1).

ISSUE 2

I.R.C. § 162(a)(1) 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 a reasonable allowance for salaries or other compensation for personal services actually rendered.

Treas. Reg. § 1.162-7(a) includes among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

Under Treas. Reg. § 1.162-7(b)(1), any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries.

The contract provision which attempts to convert disallowed expenses into compensation to Mr X, if effective, permits the C corporation to continue to deduct the amounts as salary; Mr. X would have to report the amounts as compensation.
We do not think that the expenses were incurred with the compensatory purpose required to be deducted as compensation.

Under the regulations and controlling precedent, there is a two-prong test for the deduction of compensation, first, whether the payments were reasonable as salaries and, second, whether there was a compensatory purpose. See O.S.C. & Associates, Inc. v. Commissioner, 187 F.3d 1116 (9th Cir. 1999), citing Elliott's, Inc. v. Commissioner, 716 F.2d 1241, 1243 (9th Cir. 1983); Nor-Cal Adjusters v. Commissioner, 503 F.2d 359 (9th Cir. 1974). Courts generally focus on the first prong regarding reasonableness. O.S.C.,187 F.3d at 1120; Elliott's, 716 F.2d at 1244. However, lack of compensatory purpose has been relied upon to find amounts paid to employees are not deductible even though they might have been reasonable in amount. O.S.C. & Associates; Nor-Cal Adjusters; Klamath Medical Service Bureau v. Commissioner, 29 T.C. 339 (1957), aff'd, 261 F.2d 842 (9th Cir. 1959), cert. denied, 359 U.S. 966 (1959).

Discerning whether compensation intent has been demonstrated is a factual question decided on the basis of all the facts and circumstances of a case. Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324, 1340 (1971), aff'd without opinion sub. nom. Jiminez v. Commissioner, 496 F.2d 876 (5th Cir. 1974). See Pacific Grains, Inc. v. Commissioner, 399 F.2d 603, 606 (9th Cir. 1968). A taxpayer's characterization of payments as compensation requires close scrutiny when, as here, a closely held corporation is involved. Elliott's, 716 F.2d at 1243; Paula Construction Co. v. Commissioner, 58 T.C.

1055, 1058 (1972), aff'd without opinion, 474 F.2d 1345 (5th Cir. 1973); Tool Producers, Inc. v. Commissioner, T.C. Memo. 1995-407, aff'd in an unpublished opinion, 97 F.3d 1452 (6th Cir. Sept. 10, 1996). See Treas. Reg. § 1.162-7(b)(1). That the amounts could have been reasonable in amount if paid as compensation does not undo the requirement of compensatory intent. Paula Construction, 58 T.C. at 1059; Klamath 29 T.C. at 347.

There must be an "intent to pay compensation at the time the distribution is made." Paula Construction, 58 T.C. at 1060. See King's Court Mobile Home Park v. Commissioner, 98 T.C. 511, 514 (1992). Thus, "it is settled law that such intent must be shown as a condition precedent to the allowability of a deduction to a corporation." Electric & Neon, 56 T.C. at 1340. An "intent manifested after a problem arises" is not controlling. Mores Steel Company, Inc. v. Commissioner, T.C. Memo. 1981-35; X-L Service, Inc. v. Commissioner, T.C. Memo. 1973-148. As a result, corporate taxpayers have generally not been permitted to recharacterize amounts as reasonable compensation after the fact. See, e.g., King's Court; Paula Construction; Electric & Neon; Simco Automotive Pump Co. Inc. v. Commissioner, T.C. Memo. 1999-235; Columbia Steak House II, Inc. v. Commissioner, T.C. Memo. 1981-142; Mores Steel; X-L Service. More specifically, taxpayers have not been permitted to recharacterize disallowed expenses paid for the individual recipient by the corporation. See, e.g., Compact Equipment Co. v. Commissioner, T.C. Memo. 1999-324; Prince v. Commissioner, T.C. Memo. 1997-324; B.B. Rider Corp. v. Commissioner, T.C. Memo. 1982-98, aff'd on this issue, 725 F.2d 945 (3d Cir. 1984).

Here, the amounts in question were paid without any prior intent to compensate Mr. X. Therefore, they are not reasonable compensation deductible under section 162(a)(1).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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