BRADFORD TAX INSTITUTE

Tax Reduction Letter

CLICK HERE to return to the home page

Private Letter Ruling 8321003

ISSUE:

1. Whether *section 274(a)(1)(B) of the Internal Revenue Code* disallows expenses attributable to property owned and leased by M to be used in part to entertain clients.
2. If not, whether earthen tanks and dirt roads are subject to depreciation under *section 167 of the Code*.

FACTS:

M, a corporation engaged in business as * * *, owns a parcel of property consisting of 3,049 acres of unimproved land it acquired in 1980. Located on this land are a campsite trailer, a mobile home, shed, pump, furniture, earthen tank and dirt roads. This property is enclosed by a perimeter fence and divided by cross fences.

Adjoining the property purchased by M is a parcel of property consisting of 1120 acres of unimproved land owned by M's president, A. A also acquired this land in 1980. A's land is leased to M at a rate of $10,000 a year.

Located on A's property are a tractor and implements which were acquired prior to 1980, and an earthen tank. A's property is enclosed by a perimeter fence and divided by cross fences.

The corporation purchased [*2] its property and rented the property from A for 3 intended purposes, to graze cattle on the land, to use the property as a hunting lodge for the entertainment of its customers, and to provide its 70 employees with a recreational facility. For taxable year 1980 cattle were not grazed on the land due to a drought; however, 90 cattle were grazed on the property in 1981.

Both properties were used by M in 1980 to entertain customers and as a recreational area for its employees. The guest books for 1980 indicate that the property was used a total of 42 days, 25 days by M's employees, and the remaining 17 days to entertain customers.

LAW AND RATIONALE:

Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 274(a)(1) of the Code provided, in part, that no deduction otherwise allowable shall be allowed for any item (A) with respect to an activity which is of a type generally considered to constitute entertainment unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial [*3] and bona fide business discussion, that such item was associated with, the active conduct of the taxpayer's trade or business, or (B) with respect to a facility used in connection with an activity (i.e. entertainment) referred to in subparagraph (A).

Section 274(e) of the Code provides specific exceptions to the application of *section 274(a)*. In subsection *(e)(5)* it is provided that subsection *(a)* will not apply to expenses for recreation, social or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are officers, shareholders or other owners, or highly compensated employees).

Prior to the enactment in the Revenue Act of 1978 of the present *section 274(a) of the Code* (Pub.L. No. 95-600, 1978-3 C.B. 81.) *section 274(a)(1)* disallowed deductions attributable to an entertainment facility unless the taxpayer established that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business. Also, old *section 274(a)* provided that in no event could the deductions attributable to the facility exceed the portion attributable [*4] to the taxpayer's trade or business.

At the present time Income Tax Regulations underlying new *section 274(a)* have not been promulgated; however, the regulations that were published underlying old *section 274(a)* are helpful because they provide some insight into what factors should be considered when determining whether a facility is used "primarily for the furtherance of the taxpayer's trade or business". See old *section 274(a)*. And these factors will be helpful in determining whether a facility used in connection with recreational activities for employees was "primarily for the benefit of employees". See *section 274(e)(5) of the Code*.

Section 1.274-2(e)(4)(1) of the regulations underlying old *section 274(a)* provides, in part, as follows:

> A facility used in connection with entertainment shall be considered as used primarily for the furtherance of the taxpayer's trade or business only if it is established that the primary use of the facility during the taxable year was for the purpose considered ordinary and necessary within the meaning of *section 162* and *212* and the regulations thereunder. All of the facts and circumstances of each case shall be considered in determining the primary [*5] use of the facility. Generally, it is the actual use of the facility which establishes the deductibility of the expenditures with respect to the facility, not its availability for use and not the taxpayer's principal purpose in acquiring the facility. Objective rather than subjective standards will be determinative. (Emphasis added)

Section 1.274-2(e)(4)(iii) of those regulations provides as follows:

> A taxpayer shall be deemed to have established that-
>
> (a) A facility used in connection with entertainment such as a ... hunting lodge ..., or
>
> (b) A facility for employees not falling within the scope of *section 274(e)(2)* or *(5)*, was used primarily for the furtherance of his trade or business if he establishes that more than 50-percent of the total calendar days of use of the facility by ... the taxpayer during the taxable year were days of business ...

Section 1.274-2(f)(2)(v) of the regulations, (which underlies *section 274(e)(5)*) provides, in part, that any expenditure by a taxpayer for a recreational activity (or for the use of a facility in connection therewith), primarily for the benefit of employees generally, is not subject to the limitations on allowability of deductions.

The [*6] regulations underlying old *section 274(a)* clearly demonstrate that when dealing with the issue of whether a facility has been used primarily for business, the central focus is on the number of days during the taxable year that the facility is used for business, as to the days used for nonbusiness activities. This focus even serves to override the intentions of the taxpayer.

In this case, M purchased and leased the property for 3 intended purposes, but on its return for taxable year 1980 it evaluated all the circumstances surrounding the use of the property and concluded that the depreciation would not be allowable on the trailer, mobile home and shed because they were entertainment facilities of the type governed by *section 274(a)(1)(B) of the Code*. The file does not indicate why M concluded as it did, in light of the fact that 60 percent of the days the property was used was by M's employees. This determination by M could have been based upon the fact that the availability of the property for hunting was discriminatory in favor of those employees and owners described in *section 274(e)(5) of the Code*.

If M was aware of the provisions of *section 274(e)(5)* when it made its determination [*7] that the trailer, mobile home, and shed were entertainment facilities, then that determination must apply to all of the expenses attributable to the property except those expenses such as interest and taxes that would be deductible even if the property were not used in a trade or business.

M contends that *section 274(a)(1)(B)* does not apply to property other than the trailer, mobile home and shed because a Committee Report describes a situation in which a taxpayer is allowed to deduct the expenses for a days hunt but is not allowed the expenses for overnight lodging.

The Conference Report underlying Pub.L. No. 95-600, 1968-3 C.B. 1, sets out an example wherein a salesman took a customer hunting for a day at a commercial shooting preserve and the expenses for the hunt (such as hunting rights, dogs, a guide, etc.) remain deductible. However, in the example the overnight lodging expenses are considered nondeductible. (See H.R.Rep. No. 95-1800, 95th Cong., 2nd Sess. 187, (1978), 1978-3 C.B. 223, 251.)

This example highlights the fact that the "entertainment facility rules" were not intended to disallow expenses attributable to the activity of entertaining, such as meal expenses; however, [*8] distinguishable from this example is the situation in this case where, rather than paying to hunt on a shooting preserve owned by another party, M actually owns or leases the facility. No division can be made in this case of the deductions in question between those that are attributable to the activity of entertaining and those that are attributable to the facility. If *section 274(a)(1)(B) of the Code* applies, no expenses are deductible.

As to the second issue concerning whether the earthen tanks and the dirt roads are depreciable under *section 167 of the Code*, if M can carry its burden of proof that the exception under *section 274(e)(5)* applies, the conclusion in *Rev.Rul. 69-606, 1969-2 C.B. 33*, as modified by *Rev.Rul. 75-137, 1975-1 C.B. 74*, and *Rev.Rul. 68-193, 1968-1 C.B. 79*, will apply to answer these questions.

Rev.Rul. 69-606 discusses a situation in which a taxpayer leased land to ranchers for a fixed fee. Located on the land purchased by the taxpayer for this purpose were earthen tanks or ponds used for watering livestock. Based on the fact that the taxpayer did not furnish any data that would establish any reasonable estimate of the useful lives of the earthen tanks or [*9] ponds, *Rev.Rul. 69-606* concluded that they were not depreciable under *section 167 of the Code*.

In *Rev.Rul. 68-193* the rule is set out that costs attributable to the general grading of land are capital expenditures and are generally not subject to depreciation allowances. However, the Revenue Ruling clarifies this rule by indicating that if the grading of roadways is between buildings having useful lives and the retirement of the buildings would render the roadway

useless, then the roadway is depreciable contemporaneously with the depreciable asset (the buildings) with which it is directly associated.

CONCLUSIONS:

1. In accordance with *section 274(e)(5) of the Code*, if the use of M's properties (purchased and leased) was not discriminatory in favor of employees who were officers, shareholders or other owners who own a 10 percent or greater interest in the business, or other highly compensated employees, the disallowance provision *274(a)(1)(B)* will not apply to the properties purchased and leased by M. In 1980, the properties owned and leased by M were used only to provide a facility for entertainment and recreational activities. Thus, if the exception provided by *section 274(e)(5) of the Code* [*10] was not met, no expenses (except those expenses that are allowable as deductions without regard to their connection with M's trade or business) attributable to the properties will then be deductible.

2. Assuming *section 274(a)(1)(B) of the Code* does not apply, if M is unable to provide data that establishes the reasonable estimate of the useful life of the earthen tanks, no allowance for depreciation is permitted. See section 1.167(a)-3 of the regulations and *Rev.Rul. 69-606* (as modified by *Rev.Rul. 75-137*).

3. Assuming *section 274(a)(1)(B)* does not apply, only those dirt roads that connect depreciable assets are subject to depreciation allowances. See *Rev.Rul. 68-193*.

A copy of this technical advice memorandum is to be given to the taxpayer. *Section 6110(j)(3) of the Code* provides that it may not be cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in this memorandum. See section 11.03 of *Rev.Proc. 80-21, 1980-1 C.B. 646*. However, when the criteria [*11] in section 11.04 of *Rev.Proc. 80-21* are satisfied, a technical advice memorandum is not revoked or modified retroactively, except in rare or unusual circumstances.

-END-