

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 18905
[Redacted],	)	
	)	DECISION
Petitioner.	)	
_____	)	

On June 20, 2005, the Income Tax Audit Division of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NOD) to [Redacted](petitioner) that made adjustments to the expenses claimed by the petitioner for 2003. No amount of additional tax or interest was asserted since the petitioner is an S corporation.

On June 28, 2005, a timely protest and petition for redetermination was filed by [Redacted] on behalf of the petitioner. Mr. [Redacted] is the sole shareholder of the S corporation. An informal hearing was held by telephone with Mr. [Redacted] on September 23, 2005. The Commission has reviewed the file, is advised of its contents, and hereby issues its decision affirming the NOD.

The petitioner filed an Idaho income tax return for 2003. The auditor for the Commission received accounting records on behalf of the petitioner. He examined and adjusted the accounting that was presented to him. The auditor determined that the apportionable income of the petitioner was \$65,981 for 2003.

In 2003, the petitioner claimed a \$31,004 Section 179 deduction on its federal return for a [Redacted], a travel trailer. When questioned about the purchase, Mr. [Redacted] provided the auditor with documentation and explained it was a travel trailer that was used for board meetings of the petitioner and petitioner had planned to use the travel trailer in the accounting practice which did not materialize after losing an account.

In a letter dated June 6, 2005, Mr. [Redacted] explained further that the annual board meetings were held away from the office to avoid interruptions. Petitioner had future plans to use the travel trailer for business trips relating to the accounting practice where other lodging was not readily available. Mr. [Redacted] justified the expense because the petitioner could acquire an asset that had ongoing value as opposed to spending money at other resort destinations to accommodate these meetings as well as to save costs in lodging for anticipated work related to the accounting practice.

Mr. [Redacted] also explained that the travel trailer was used by other family members at the board meetings and that his family was allowed to use the travel trailer in exchange for storing the trailer on the shareholder's personal property in lieu of rent.

The auditor dismissed these arguments and disallowed the deduction because the expense was not ordinary and necessary in accordance with IRC section 162. The auditor also determined that the travel trailer was a lodging facility used for entertainment purposes under IRC section 274. Therefore, the auditor denied the deduction based on those two code sections as well as related court cases. The Commission agrees with the auditor's findings.

Mr. [Redacted] maintained that the use of the travel trailer met all of the requirements to be an ordinary and necessary expense of the S corporation and disagreed with the audit findings.

With the basis of the facts established, we next turn to the relevant tax law. In New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934), the Supreme Court stated "Whether and to what extent-deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can any particular deduction be allowed." Thus, a taxpayer claiming a deduction must be able to point to an appropriate statute to show that the deduction is allowable.

Even though the ability to claim the deduction is established, a taxpayer may be required to substantiate the expense. (See Barnes v. Comr., 408 F.2d 65,69 (7th Cir. 1969)). This principle is set forth in Harrell v Tomlinson, 63-1 USTC Para. 9120, p.87, 149, where the court stated:

It is likewise important for a taxpayer claiming deductions to be in a position to establish proof of the correctness of the claimed amounts because the Commissioner's determination has the presumption of correctness and taxpayer has the burden of proving it to be wrong.

Regarding the case at hand, the petitioner maintains that the use of the travel trailer was ordinary and necessary relating to its annual meetings and its planned use of the trailer for the benefit of the related accounting practice.

Internal Revenue Code (IRC) Section 162 allows a deduction for all the ordinary and necessary expenses paid by the business. On the other hand, IRC Section 262 provides that no deduction shall be allowed for personal, living, or family expenses.

A review of the information submitted to substantiate the use of the trailer by the petitioner shows that the trailer was used generally twice a year: once on Memorial Day weekend for the board meeting and once on Labor Day weekend by the shareholder personally in exchange for storing the trailer on his personal property when it was not in use by the S corporation. The records showed that the board meeting was only held on Saturday of the Memorial Day weekend with personal use of the trailer by the shareholder and his family for the rest of the Memorial Day weekend. The annual board meeting has been at [Redacted] according to the log information. The S corporation did not use the trailer with regard to the accounting practice as initially planned due to the loss of a client.

In a somewhat similar case, a taxpayer (Stan Frisbie, Inc., v. Comm., TC Memo 1990-419, claimed that its expenses relating to a sailboat were ordinary and necessary in relation to its real estate business. The tax court stated in that case:

Section 162 allows a deduction for all ORDINARY AND NECESSARY expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162 is not an unrestrained grant for taxpayers to deduct all expenses to support their flamboyant lifestyles. One cannot live "the life of Riley" and expect the Government to underwrite a part thereof through the entitlement of tax deductions.

The United States Supreme Court and this Court have defined "ordinary" for purposes of section 162 to mean "normal, usual or customary." *Deputy v. duPont*, 308 U.S. 488,496 (1940); *Challenge Manufacturing Co. v. Commissioner*, 37 T.C. 650, 660 (1962). The element of reasonableness is inherent in the phrase "ordinary and necessary." *United States v. Haskel Engineering & Supply Co.* 380 F.2d 786,788-789 (9th Cir. 1967); *Commissioner v. Lincoln Electric Co.*, 176 F.2d 815817 (6th Cir. 1949).

We agree with respondent that the sailboat was purchased for the personal aggrandizement of Frisbie and that it was used to support his flamboyant lifestyle.

In the case at hand, the travel trailer was not used by the petitioner in its business operations other than to accommodate the petitioner's annual meeting which could have been held anywhere with little expense. The other main uses claimed were to reimburse the shareholder for storing the trailer. An ordinary businessman would not incur such expense as ordinary or necessary where the expense provides no benefit to the business itself.

All of the above facts show that this expenditure was nothing more than a disguised benefit to the shareholder. This does not mean that a travel trailer could never be used in an accounting practice or any other business; it only means that, given the facts in this case, the expenses associated with the travel trailer were not ordinary or necessary. Thus, the travel trailer

expenses deducted on the return are determined not to be ordinary and necessary expenses of the business for purposes of IRC Section 162.

Furthermore, Congress enacted IRC Section 274 requiring additional tests in addition to the "ordinary and necessary" test of IRC Section 162 previously discussed in order to deduct any expense relating to business entertainment. Specific to this case, IRC Section 274(a) provides that "No deduction otherwise allowable under this chapter shall be allowed for any item. . . (B) With respect to a facility used in connection with an activity referred to in subparagraph (A)." The activity referred to is "an activity which is of a type generally considered to constitute entertainment, amusement, or recreation."

Federal Tax Regulation 1.274-2(a) (2) similarly provides that "no deduction otherwise allowable under chapter I of the Code shall be allowed for any expenditure paid or incurred after December 31, 1978, with respect to a facility used in connection with entertainment." Although the term "facility" is not defined in the code or regulations, the Tax Court stated in Thomas Brown Ireland v. Comm., 89 TC 978 (1987):

The legislative history reveals that the term facility "includes any item of real or personal property which is owned, rented, or used by a taxpayer in conjunction or connection with an entertainment activity." It includes such items as "yachts, hunting lodges, fishing camps, swimming pools, tennis courts, and bowling alleys. Facilities also may include airplanes, automobiles, hotel suites, apartments, and houses (such as beach cottages and ski lodges) located in recreational areas." However, the deductibility of expenses relating to the property is not affected unless the property is used in connection with entertainment. H. Rept. 95-1800 (Conf.)(1978), 197803 C.B. (vol. 1) 521,583-584; S. Rept. 95-1263 (1978), 1978-C.B. (Vol. 1) 315, 472-473.

With this description, the travel trailer clearly fits within the list of items considered to be facilities. The question to be determined in the case at hand is whether or not the travel trailer was a facility used in a manner that would be considered "entertainment."

Subsection (b)(1)(i) of Federal Tax Regulation 1.274-2 defines "entertainment" to include activities "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." Then subsection (b)(1)(ii) states that "An objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone."

In a similar case, the Tax Court explained in Thomas Brown Ireland v. Comm., supra., how it went through this objective test in making its determination in regard to the use of beach front property by the taxpayers relating to their business by stating:

Thomas held various meetings at the Northport property. He met with investment advisors and with current and prospective clients in order to discuss investment opportunities. He also met with salesmen, trainees, and other partners in Roney & Co. Under an objective standard, these activities would not be considered to constitute entertainment. However, on occasion, the families of the individuals attending the meetings accompanied them and we seriously doubt that the family members attended the business meetings. Although it was not developed in the record what activities the family members engaged in while they were at the Northport property, we simply point out that this was three acres of beach front property. It was also not developed in the record whether the family members spent the night. However, the meetings typically lasted for several days and there were lodging facilities. If they accompanied the individuals attending these meetings, we think it follows that they spent the night. Under an

objective standard, these outings appear to be in effect vacation trips for the family members of the business associates of Thomas. Therefore, petitioners have failed to establish that the Northport property was not used in connection with entertainment as defined in section 274(a)(1)(B).

Petitioners contend that the amount of use of the Northport property by family members of business associates of Thomas was insignificant. However, petitioners offered no evidence as to how many family members accompanied the business associates or on how many occasions family members accompanied the business associates. In short, petitioners failed to establish that the use of the Northport property by family members of the business associates of Thomas was insignificant. In any event, the 1978 amendment indicates that any use of the facility, no matter how small, in connection with entertainment is fatal to the claimed deduction. Section 274(a)(1)(B), as amended operates as an absolute bar.

See also the similar court decisions of Harrigan Lumber Co., Inc. v. C.I.R., 88 T.C. 1562 (1987), Nguyen v. C.I.R., 56 T.C.M. 1432 (1989), and Security Associates Agency Ins. Corporation v. C.I.R., 53 T.C.M. (1987), which similarly provide that any entertainment associated with the facility proves fatal to any deductions regarding the facility.

In regard to the case at hand, the petitioner stated in its letter that "The board members have children so they wanted to (have) a place they could take their children and spend time with them when they were not conducting board business." The log shows that the annual meetings were held at [Redacted] for four days. Similar to Thomas above, the explanations provided do not indicate what activities the children of the board members participated in while they were at [Redacted] but apparently it was recreational activity with their parents. Also from the record, it appears that the children spent the night with their parents. Under the objective test outlined above, the annual meetings were also vacation trips for the board members' families. This shows that the trailer was used for entertainment purposes as outlined in the code and regulations discussed above.

Furthermore, the shareholder's use of the trailer in exchange for storage fees was for personal recreation. This use of the facility also fits within the definition of using the corporate facility for entertainment purposes under the objective test for purposes of IRC Section 274. As a result of using the travel trailer, a facility used for entertainment purposes within the meaning of IRC Section 274, the related expenses of the facility cannot be allowed. IRC Section 274(g) also states that where the deductions relating to a facility are disallowed they are "treated as an asset used for personal, living, and family purposes (and not as an asset used in the trade or business)."

On June 30, 2005, a note written on a copy of Mr. [Redacted]'s copy of his "Individual Income Tax Audit Changes" was received. It stated in pertinent part:

. . . We disagree with your position on [Redacted]. . . .

Prior to the taxpayers' informal hearing, Mr. [Redacted] sent a letter dated July 13, 2005, in which he addressed disagreement with the auditor's findings.

The first item Mr. [Redacted] took issue with was the classification, under section 274(a)(1), of the travel trailer as an entertainment or recreational deduction. Mr. [Redacted] stated that the corporate minutes and log book clearly support the intent of the board to use this trailer only for business purposes. Mr. [Redacted] included Internal Revenue Code section 274(a)(1) which stated in part:

(A) Activity

With respect to an activity which is of the type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise) that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility

With respect to a facility used in connection with an activity referred to in subparagraph (A).

Mr. [Redacted] states that, since a bona fide business meeting was held, the assertion of section 274 is not appropriate with the facts of this case.

What Mr. [Redacted] fails to mention is that the shareholders take their children on these trips. The court cases previously cited have found that the use of a facility by family members would classify it as an entertainment facility.

The second item Mr. [Redacted] took issue with was the auditor's position with regard to IRC § 162. Mr. [Redacted] stated:

The auditor quotes a tax case that indicates that the taxpayer is living a "life of Riley" and a "flamboyant lifestyle." He further says "the travel trailer was not used by the corporation other than the annual meeting. If the annual meeting was all this trailer was used for it should still be fine because it meets the ordinary, necessary and reasonable test. However, there were plans to use this trailer in other business uses that fell through after the purchase was made. If there is a crystal ball that allows us as businessmen to see the future we wouldn't plan for it in advance. If that advance planning does not go according to plan that does not negate the tax deduction.

It does not matter that the petitioner had planned to use the trailer for other business uses; it only matters how it was actually used. In Simonson v. U. S., 752 F.2d 341 (1985), the Court held that the taxpayers were not entitled to depreciation deductions on a truck and trailer purchased with the intent to start a grain-hauling business but never used for that or any other profit-making purpose.

Mr. [Redacted] then addresses the auditor's position that the annual board meeting could have been held at little or no cost. Mr. [Redacted] stated:

It was explained to the auditor that the company was having a difficult time scheduling a meeting that was not canceled or postponed because of other conflict or interruptions. When the meetings were held they were not very productive because of interruptions and distractions.

The auditor further states, "that an ordinary businessman would not incur such expense as ordinary or necessary where the expense provides no benefit to the business itself." It is apparent the auditor has never participated in a productive board meeting and so he has little or no value for their purpose. The fact that the bylaws of the corporation require that an annual meeting be held also seems to elude his observation. During some of our recent board meetings we have considered the possible admission of a new partner to the [Redacted] practice, we have considered the need to let an employee go because of the loss of a large client, we have considered ways to have our firm grow or with the downturn in the [Redacted] economy ways to still stay profitable. This forward planning has allowed the company to grow and stay strong even through a changing economy. If that is not valuable to a company I do not know how to run a business.

As to the question is the expense reasonable? I explained to the auditor that after evaluating the on going cost of traveling somewhere, acceptable to the board, the annual cost would be from \$2,000 to \$4,000 each and every year. In making there [sic] decision the board considered the true cost of purchasing this trailer and they felt the annual cost would be less by purchasing the trailer considering the net tax benefits and projected value of this trailer after 10 years of use. The board also anticipated other uses as mentioned before which would increase the benefit to the corporation. The test is "whether a hard-headed businessman would have incurred it under the circumstances." This trailer was purchased as using sound business practices and has proved its value to the business and will continue to do so in the future.

The Commission agrees with the auditor's position concerning whether the purchase of the trailer was an "ordinary and necessary expense." Each year, the two board members could have hired a babysitter for their children and rented a motel room for eight hours to conduct their annual board meeting at a cost that would have been considerably less than an expense of \$38,000 for a travel trailer.

In a letter dated September 27, 2005, Mr. [Redacted] provided a copy of a court case which he stated further supports the deduction of the trailer.

The case that was provided, United Title Insurance Co. v C.I.R., 55 T.C.M. 34 (1988), does not apply to the case at hand. The board meetings and conferences in the United case were held out of state to get the business associates of United to attend. The petitioner's out-of-state board meetings held by the board members only benefited the petitioner's sole shareholder, his wife, and their children.

In summary, the expenses associated with the travel trailer are disallowed because they fail to meet the requirements of IRC Section 162 regarding the ordinary and necessary test and the travel trailer is a facility used in conjunction with entertainment that also denies the deductions in accordance with IRC Section 274. The expenses related to the travel trailer are claimed on the federal tax return as Section 179 expenses of \$31,004. An adjustment is made disallowing this deduction.

For Idaho purposes, the petitioner reported an addition on the Idaho return of \$7,459 relating to federal Section 179 Expenses in excess of the amount reported on the state Form 4562 in regard to the trailer. The return was filed at a time when the Internal Revenue Code for Idaho purposes had not adopted the \$100,000 Section 179 expense. The difference related to the amount of basis remaining in the travel trailer above the \$25,000 Section 179 expense allowed at the time for Idaho purposes. As a result of disallowing the Section 179 expense on the federal return in regard to the travel trailer, this addition needs to be reversed.

For Idaho purposes, the petitioner reported a subtraction on the Idaho return of \$858 relating to Idaho depreciation in excess of the amount reported on the federal Form 4562. This difference relates to the additional depreciation allowed on the remaining basis of the travel

trailer relating to the Section 179 limitation of \$25,000 previously discussed. As a result of disallowing the Section 179 expense on the federal return in regard to the travel trailer, this subtraction needs to be reversed.

The Commission has reviewed the computations in the file and finds that they appear to be correct. The income of the S corporation passes through and is to be reported by the shareholder of the S corporation. The Commission hereby affirms the auditor's determination.

WHEREFORE, the Notice of Deficiency Determination dated June 20, 2005, is hereby APPROVED, AFFIRMED, AND MADE FINAL.

An explanation of the petitioner's rights to appeal this decision is enclosed with this decision.

DATED this \_\_\_ day of \_\_\_\_\_, 2006

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_, 2006, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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