IRS Chief Counsel Advice Provides Guidance on Entertainment Disallowance for Sole Proprietors

Sept. 17, 2021

> This NBAA resource is intended to provide members with an introduction to the rules that relate to the entertainment use disallowance. It is intended only to provide an illustrative introduction to the subject matter. Since the information is general in nature, it is no substitute for the advice of legal and tax advisors addressing a specific set of facts that readers may face.

by John B Hoover

On April 2, 2021, the IRS issued Chief Counsel Advice (CCA) 2021-17-012 to explain that sole proprietor flights are generally not subject to the employer-provided aircraft rules in Internal Revenue Code § 274(e)(2), (9) and Treas. Reg. § 1.274-9, -10. Thus, it is irrelevant whether the sole proprietor is a specified individual for purposes of these rules. Moreover, sole proprietors are generally not required to apply the occupied seat method or the flight-by-flight method under Treas. Reg. § 1.274-10(e) to allocate costs for purposes of the entertainment disallowance.

Download CCA 2021-17-012 (PDF) (https://nbaa.org/wp-content/uploads/flight-department-administration/tax-issues/federal-taxes/20210402-IRS-Chief-Counsel-Advice-CCA-2021-17-012.pdf)

While the CCA comments on the allocation methods, NBAA proactively sought clarification on this issue in a meeting with the IRS. Following the meeting, NBAA sent a letter confirming our understanding that in view of applicable law, the CCA does not present the IRS position on the proper method to allocate costs of sole proprietor flights for purposes of the entertainment disallowance. The IRS verbally confirmed its agreement with the points in NBAA's letter.

Read NBAA's letter regarding CCA-2021-17-012 (PDF) (https://nbaa.org/wp-content/uploads/flight-department-administration/tax-issues/federal-taxes/20210826-NBAA-Letter-IRS-on-CCA-2021-17-012.pdf)

Existing law indicates that the primary purpose method ("Primary Purpose Method") should apply to calculate the entertainment disallowance for sole proprietor flights. However, taxpayers should be aware that there is a potential risk that IRS agents will assert in tax audits that the costs of a flight must be allocated among each passenger to calculate the entertainment disallowance.

Sole Proprietor Flights

Sole proprietor flights are flights operated by an individual, where the business flights are for a business operated by the individual. These flights are in contrast to employer-provided flights, where the employer operates the aircraft and personal flights are provided as compensation to the individual. In a sole proprietor flight, the aircraft or the business could be operated by a disregarded entity owned by the individual such as a single-member limited liability company.
Another context in which sole proprietor flights may arise is when a partner in a partnership operates an aircraft on partnership business. The partner would deduct

the allocable costs of the aircraft against his or her distributive share of partnership profit or loss. The partner's costs of personal or entertainment flights would not be deductible.

> The partner would typically deduct his or her partnership expenses against his or her Schedule K-1 pursuant to I.R.C. § 707. In such a case, it is important to establish that the partnership has a policy stating that it expects the partner to incur the expense although the partnership will not reimburse it. See Noyce v. Comm'r, 97 T.C. 670 (1991).

It is important to distinguish between sole proprietor flights conducted by the sole proprietorship and employer-provided flights conducted by the sole proprietorship. If a sole proprietor and his or her family members or other personal guests are on a flight, then the flight would be a sole proprietor flight and not an employer-provided flight. On the other hand, if the sole proprietor is accompanied by one or more employees of the sole proprietorship traveling on sole proprietorship business or for personal purposes on a flight provided to them as compensation, then the flight would be a mix of sole proprietor flight for the sole proprietor and employer-provided flight for the employees.

In the case of a mix of sole proprietor flight and employer-provided flight, if the sole proprietor flight is accounted for under the Primary Purpose Method, then, to provide a consistent allocation method overall, it would appear that the employer-provided flight would need to be accounted for under the "Flight-by-Flight" method rather than the "Occupied Seat Method" under Treas. Reg. § 1.274-10(e).

The CCA Clarifies That Sole Proprietor Flights Are Not Governed by the Regulations Governing Employer-Provided Flights

In the case of employer-provided flights, § 274(e)(2), (9) provides that the entertainment disallowance applies to the employer's cost of entertainment flights provided as compensation to specified individuals in excess of the amount reported to them as compensation, typically at Standard Industry FareLevel (SIFL) rates. The imputed income rules, including the SIFL rates, are set forth in Treas. Reg. § 1.61-21(g).

Treas. Reg. § 1.274-10(e) provides that this disallowance applies on a passenger-by-passenger basis, under either the occupied seat method or the flight-by-flight method. These passenger-by-passenger allocation methods typically result in a greater disallowance of costs than the Primary Purpose Method, because they result in the disallowance of costs with respect to individual passengers traveling for entertainment purposes on flights conducted primarily for nonentertainment business purposes. In contrast, under the Primary Purpose Method (which is not allowed for employer-provided flights) there would be no entertainment disallowance for a flight conducted primarily for nonentertainment business purposes.

While § 274(e)(2), (9) clearly apply only to employer-provided flights, there was some concern that perhaps the regulations thereunder (Treas. Reg. § 1.274-10) somehow applied to sole proprietor flights in addition to employer-provided flights. From time to time, IRS auditors have asserted that a sole proprietor was a "specified individual" and therefore the passenger-by-passenger allocation methods apply to the sole proprietor's flights.

Fortunately, the CCA clearly states in its "Conclusion" the IRS position that § 274(e), (9) and Treas. Reg. § 1.274-10 do not apply to sole proprietor flights. This should put an end to IRS auditors asserting that Treas. Reg. § 1.274-10(e) requires the passenger-by-passenger allocation methods for sole proprietor flights. The CCA also makes it clear that it is irrelevant whether a sole proprietor is a "specified individual."

The CCA Does Not Provide Guidance Regarding the Allocation Method Required for Sole Proprietor Flights

The CCA confirms that for purposes of calculating the ordinary and necessary business expenses under I.R.C. § 162(a), the costs of sole proprietor flights should be allocated to each flight based on the primary purpose of the flight (Primary Purpose Method) as provided under Treas. Reg. § 1.162-2(b). This statement is clearly supported by the regulations and seems uncontroversial.

However, at the end of the CCA are several sentences commenting that the Primary Purpose Method is not a reasonable allocation method for sole proprietors to use for the entertainment disallowance. As confirmed by a letter from NBAA to the IRS (https://nbaa.org/wp-content/uploads/flight-department-administration/tax-issues/federal-taxes/20210826-NBAA-Letter-IRS-on-CCA-2021-17-012.pdf), the IRS indicated that these comments on allocation methods for purposes of the entertainment disallowance do not purport to require any particular allocation method and do not present a specific IRS position on the allocation methods required for sole proprietors.

Current Law Supports the Primary Purpose Method for the Entertainment Disallowance for Sole Proprietor Flights

As noted above, the entertainment regulations at Treas. Reg. § 1.274-10 do not prescribe an allocation method for sole proprietor flights. While the CCA suggests (although not as the IRS position) that the Primary Purpose Method is not reasonable for sole proprietor flights, there are several reasons that the Primary Purpose Method could remain applicable for the entertainment disallowance for sole proprietors.

Before the entertainment disallowance in § 274(a) was enacted in 1962 (P.L. 87-834, § 4), the IRS made it clear that the appropriate allocation method for travel expenses was based on whether the trip was primarily personal or business. Treas. Reg. § 1.162-2(b); Rev. Rul. 56-168, 1956-1 C.B. 93. After the entertainment disallowance was enacted, the Tax Court has continued to apply the Primary Purpose Method to cars. In *Pohl v. Commissioner*, T.C. Memo. 1990-298, the Tax Court rejected the IRS Agent's position that when a husband traveled for business and his wife accompanied him traveling for personal purposes, one-half of the cost of the rental car should be nondeductible. The court held that only the marginal cost of the wife's personal travel should be nondeductible. (See also IRS Pub. 463, at 5.) Since the Primary Purpose Method is the allocation method required for cars, it would seem difficult for the IRS to prevail in arguing that it is not a reasonable method for aircraft.

The Primary Purpose Method has been applied by the courts to allocate travel expenses for private aircraft in sole proprietorship structures. *Noyce v. Comm'r*, 97 T.C. 670 (1991); *French v. Comm'r*, T.C. Memo. 1990-314. Moreover, the court in *Southerland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197, 198 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.* 2002-1 C.B. xvii, applied the Primary Purpose Method in an employer-provided aircraft structure prior to the amendment of § 274(e)(2), (9) and the issuance of Treas. Reg. § 1.274-10 which imposed the passenger-by-passenger method only on employer-provided flights. To now conclude that the Primary Purpose Method is unreasonable would mean that the IRS would be concluding that the analysis in these court cases is unreasonable. Such a conclusion would seem difficult for the IRS to maintain in view of the fact that no court has applied a passenger-by-passenger allocation method in a sole proprietor structure.

The applicability of the Primary Purpose Method to aircraft is also required under the substantiation rules for listed property (which includes aircraft). Temp. Treas. Reg. § 1.274-5T(b)(6)(i)(B) provides that taxpayers are required to account for the hours of use for cars or other means of transportation. The regulation does not further call for each use of a transportation property to be accounted for separately for each passenger. The regulation permits the Commissioner to approve an alternative

method. However, the commentary on the Primary Purpose Method in the last paragraph of the CCA does not constitute the approval of an alternative method for the following reasons:

- It was not intended to represent the IRS position, as confirmed by the NBAA letter.
- It does not purport to affirmatively approve any particular allocation method.
- It was issued in a chief counsel memorandum, which is not binding precedent as provided in § 6110(k)(3).

Section 274(m)(3) and Treas. Reg. § 1.162-2(c) impose limits on the deductibility of travel by an accompanying spouse, family, or personal guests. This statute and regulation do not prescribe required allocation methods. However, the reasons set out above support the conclusion that the Primary Purpose Method would also apply to these deduction limitations in the case of sole proprietor flights.

John Hoover is a Partner in Holland & Knight's Tysons office and member of the Asset Finance Group. Hoover focuses his practice on federal and state tax planning, compliance, and controversy matters involving business aircraft and tax-exempt organizations. He serves as chair of NBAA's Tax Committee and can be reached at John.Hoover@hklaw.com (mailto:John.Hoover@hklaw.com).