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THE ENTERTAINMENT FACILITY RULES OF SECTION 274 AND CORPORATE-OWNED CONDOMINIUMS

by

MARY E. VANDENACK*

INTRODUCTION

In the past decade Congress has focused a lot of attention on limiting or eliminating deductions for lavish entertainment. An area where deductions have been virtually eliminated is that of "entertainment facilities." This Article examines the disallowance provisions of I.R.C. § 274¹ concerning entertainment facilities in the context of corporate-owned entertainment facilities.

To aid the discussion of § 274, this Article focuses on a hypothetical set of facts. Corporation owns two condominiums. One condominium is located in a Colorado resort area and is affectionately called Tummyache. The other condo is located in a resort area in Florida and is affectionately called Four Clovers.

Tummyache is used by customers, prospective customers, and employees of Corporation, and sometimes by individuals unrelated to Corporation. The policy of Corporation is to treat use of the condo by employees as compensation. The value of such use is treated as a taxable fringe benefit to the employee and included as compensation on the employee's W-2. The usage of the condo is about forty percent by employees and sixty percent by customers and others.

Four Clovers is used only by one of Corporation's stockholders, Emma. Emma stays at Four Clovers for about four months each winter and rents the condo during that time. Four Clovers is not available to employees or customers. Four Clovers is not held out for rent when Emma is not staying there.

ENTERTAINMENT FACILITY RULES

In General

Section 162 of the Internal Revenue Code allows "a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."² Section 274 is a disallowance provision.³ Even

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¹ I.R.C. § 274(a) (1992).

² I.R.C. § 162 (1992).

³ See I.R.C. § 274(a) (1992).

if a taxpayer demonstrates that an expense is allowable under § 162, the expense may be disallowed by operation of § 274 or another disallowance provision.

Section 274 relates specifically to entertainment expenses. Section 274(a) operates to disallow deductions in connection with an entertainment facility. Section 274(a)(1)(B) provides in pertinent part:

(a) ENTERTAINMENT, AMUSEMENT, OR RECREATION. –

(1) IN GENERAL. – No deduction otherwise allowable under this chapter shall be allowed for any item –

* * *

(B) FACILITY. – With respect to a facility used in connection with an activity referred to in subparagraph (A).⁴

The activity referred to in subparagraph (a) is "an activity which is of a type generally considered to constitute entertainment amusement, or recreation."⁵ Thus, § 274(a)(1)(B) operates to disallow expenses with respect to an "entertainment facility."

What Is A Facility?

The term "facility" is not statutorily defined. However, the legislative history indicates 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."⁶ Vacation homes and cabins or other buildings in resort areas have been held to be facilities for purposes of § 274.⁷ However, otherwise qualifying business expenses relating to a "facility" are not affected unless the "facility" is used "in connection with entertainment."

What Is Entertainment?

"Entertainment" is defined in the regulations as "any activity which is of a type generally considered to constitute entertainment, amusement, or recreation."⁸ The regulations provide for an objective test under which the issue is whether the activity is of a type that would generally be considered entertainment.⁹

⁴ I.R.C. § 274(a)(1)(B) (1992).

⁵ I.R.C. § 274(a)(1)(A) (1991).

⁶ H.R. CONF. REP. NO. 1800, 95th Cong., 2d Sess. (1978); 1978-3 C.B. 521, 583-84 (1978); S. REP. NO. 1263, 95th Cong., 2d Sess. (1978); 1978-3 C.B. 315, 472-73; Treas. Reg. § 1.274-2(e)(2) (as amended in 1985).

⁷ See *Ireland v. Commissioner*, 89 T.C. 978 (1987); *McReavy v. Commissioner*, 57 T.C.M. (CCH) 133 (1989).

⁸ Treas. Reg. § 1.274-2(b)(1)(i) (as amended in 1985).

⁹ *Id.*

What Is Meant By "In Connection With"?

Section 274(a)(1)(B) disallows all expenses with respect to a facility if the facility is used to *any extent at all* for entertainment.¹⁰ That is, § 274(a)(1)(B), as amended, operates as an absolute bar to the deductibility of expenses with respect to a facility, if *any use* of the facility, *no matter how small*, involves entertainment.¹¹

Section 274(a)(1)(B) was amended in 1978.¹² Prior to that amendment, § 274(a)(1)(B) disallowed expenses with respect to an entertainment facility *unless* the taxpayer could establish that the primary use of the facility was in furtherance of the taxpayer's trade or business.¹³ The "unless" portion of the statute was deleted in the 1978 amendment.¹⁴ As a consequence of this deletion, the primary use of the facility is no longer relevant.¹⁵

Section 1.274-2(e)(2)(ii) of the Income Tax Regulations contains an "incidental use" exception.¹⁶ After § 274(a)(1)(B) was amended in 1978, the Regulation was also amended.¹⁷ The heading to § 1.274-2(e) now reads "Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or at any time with respect to clubs."¹⁸ This amendment indicates that the "incidental use" exception applies only to expenditures paid or incurred prior to January 1, 1979.¹⁹

I.R.C. § 274(a)(1)(A) disallows entertainment expenses unless a taxpayer establishes that the item is "directly related to" or in some cases "associated with" the taxpayer's business.²⁰ The "directly related to" and "associated with" exceptions of § 274(a)(1)(A) do *not* apply to § 274(a)(1)(B) with respect to entertainment facilities.²¹

Are The Corporation Condominiums "Entertainment Facilities"?

Both of the Corporation condominiums can be classified as entertainment facilities. One of the examples of an entertainment facility given in the regulations

¹⁰ *Ireland*, 89 T.C. at 983.

¹¹ *Id.* See also *Security Assocs. Agency Ins. Co. v. Commissioner*, 53 T.C.M. (CCH) 1239 (1987).

¹² *Ireland*, 89 T.C. at 981.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Treas. Reg. § 1.274-2(e)(2)(ii) (as amended in 1985).

¹⁷ Robert Zbacnik & Jim Ellerbeck, "Entertainment Facility" Takes on a New Meaning, 19 TAX ADVISER 852, 852 (Dec. 1988).

¹⁸ See Treas. Reg. § 1.274-2(e) (as amended in 1985).

¹⁹ *Ireland*, 89 T.C. at 984.

²⁰ See I.R.C. § 274(a)(1)(A) (1992).

²¹ See *Stan Frisbie, Inc. v. Commissioner*, 60 T.C.M. (CCH) 440 (1990).

is a vacation home in a resort area.²² Because both condominiums are in vacation areas and are used for activities that are generally considered to be recreation or entertainment, both condos would fall within the definition of "entertainment facilities."

What Deductions Are Disallowed?

Section 274 disallows expenses in connection with an entertainment facility, whether or not those expenses are true business expenses.²³ If the facility is used for entertainment, then all deductions with respect to the facility are foreclosed.²⁴ Disallowed deductions include maintenance expenses, operating expenses, depreciation, and loss on the sale of the facility.²⁵

Nevertheless, the rule barring deductibility of expenses for entertainment facilities does not apply to certain expenditures. For example, out-of-pocket expenses incurred contemporaneously with an entertainment activity are not subject to the rule that generally disallows facility-related expenditures (e.g. food consumed at a meeting).²⁶ The rule also does not apply to expenses that are allowed without regard to the connection of the expenses to the taxpayer's trade or business, such as taxes, interest, and casualty losses.²⁷

What Happens If Expenses Are Disallowed?

The statute provides that if expenses are disallowed "with respect to any portion of a facility, such portion shall be treated as an asset used for personal, living, and family purposes and not an asset used in the trade or business."²⁸ If a corporate-owned vacation condominium is found to be an entertainment facility, then the condominium will be treated the same for tax purposes as a personal residence.²⁹ "If deductions are disallowed under [§ 1.274-2] with respect to any portion of a facility, then such portion shall be treated as an asset which is used for personal, living, and family purposes."³⁰ The "basis of such a facility will be adjusted for purposes of computing depreciation deductions and determining gain

²² Treas. Reg. § 1.274-2(c)(2)(i) (as amended in 1985).

²³ See *Security Assocs. Agency Ins. Corp. v. Commissioner*, 53 T.C.M. (CCH) 1239 (1987).

²⁴ *Id.*

²⁵ See Charles E. Federanich, *Travel and Entertainment Rules From a Practice Development Point of View*, TAX PRACTICE MANAGEMENT, Mar. 1992, p. 188-189.

²⁶ In *Dodd v. Commissioner*, 63 T.C.M. (CCH) 3141 (1992), the court found that expenditures for beer, champagne, and snacks provided on a hot air balloon ride were deductible under § 162 (subject to the eighty percent entertainment limitation) as business expenses that were incurred at the time of the entertainment activity but were not "with respect to" the entertainment facility. The hot air balloon was found to be an entertainment facility.

²⁷ See *McReavy v. Commissioner*, 57 T.C.M. (CCH) 133 (1989) (court disallowed all expenses except interest and property taxes); see also I.R.C. § 274(f); *Dodd*, 63 T.C.M. (CCH) 3141.

²⁸ I.R.C. § 274(g).

²⁹ See *W.L. Schautz Co. v. United States*, 567 F.2d 373, 375 (Ct. Cl. 1977).

³⁰ Treas. Reg. § 1.274 (as amended in 1985).

or loss" on sale in the same manner as other property held partly for business and partly for personal purposes.³¹

One of the dangers of disallowance under § 274 is that the disallowed expenditures may be treated as constructive dividends to the shareholders of the corporation. "Any expenditure made by a corporation for the personal benefit of its stockholders, or making corporate-owned facilities available to shareholders for their personal benefit, may result in the receipt by the shareholders of constructive dividends."³² The standard for determining the amount of a constructive dividend where the corporation has title to the property is the fair rental value of the property.³³

ARE THERE ANY APPLICABLE EXCEPTIONS TO THE RULE?

Recreational Expenses For Employees

I.R.C. § 274(e)(4) provides that the disallowance provisions of subsection (a) shall not apply to "Expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees (other than employees who are highly compensated employees within the meaning of § 414(q))."³⁴ Generally, this exception applies to the

usual employee benefit programs such as expenses of a taxpayer . . . in holding Christmas parties, annual picnics, or summer outings, for his employees generally, or . . . of maintaining a swimming pool, baseball diamond, bowling alley, or golf course available to his employees generally. Any expenditure for an activity which is made under circumstances which discriminate in favor of employees who are officers, shareholders, or other owners, or highly compensated employees shall not be considered made primarily for the benefit of employees generally. On the other hand, an expenditure for an activity will not be considered outside this exception merely because, due to the large number of employees involved, the activity is intended to benefit only a limited number of such employees at one time, provided the activity does not discriminate in favor of

³¹ *Id.*

³² *Stan Frisbie, Inc. v. Commissioner*, 60 T.C.M. (CCH) 440 (1990) (citing *Ashby v. Commissioner*, 50 T.C. 409, 417 (1968)).

³³ *Id.* (citing *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225, 1240-41 (1971)).

³⁴ I.R.C. § 274(e)(4) (1992). I.R.C. § 414(q) states "[t]he term 'highly compensated employee' means any employee, who during the year or preceding year - (A) was at any time a 5-percent owner, (B) received compensation from the employer in excess of \$75,000, (C) received compensation from the employer in excess of \$50,000 and was in the top-paid group of employees for such year, or (D) was at any time an officer and received compensation greater than 50 percent of the amount in effect under § 415(b)(1)(A) for such year." I.R.C. § 414(q). The \$75,000 and \$50,000 amounts are adjusted annually for costs of inflation. See I.R.C. § 414(q) (1992); I.R.C. § 415(b)(1)(A) (1992); I.R.C. § 415(d) (1992).

officers, shareholders, other owners, or highly compensated employees.³⁵

The actual use of property is the controlling factor in determining whether the § 274(e)(4) exception applies. If the property is never or rarely used by employees, then the property will not be considered to be held "primarily for the benefit of employees."³⁶ However, "a reasonable classification of eligible employees, whether by time when the recreational facilities may be enjoyed [or] by nature of the work, etc., would appear to be within the provisions of § 274(e)(4)."³⁷ For example, the Tax Court has upheld a company policy for providing cruises to employees that in effect resulted in the exclusion of temporary employees of the company.³⁸ Section 274(e)(4) does not require absolute equal access by all employees to recreational facilities but allows flexibility based upon a nondiscriminatory, reasonable, and realistic method of selecting participants.³⁹

The Code, Regulations, and case law do not provide much in the way of specific guidance as to what is meant by "primarily for the benefit of." However, in *American Business Service Corp. v. Commissioner*, the court noted that less than half of those who participated in cruises provided by the company were officers, stockholders, or highly-compensated employees. The court found the exception applied in that case.⁴⁰ In *McReavy v. Commissioner*,⁴¹ the court found that a lake property was not primarily for the benefit of employees because the use by employees other than the shareholders was minor and employees other than shareholders were usually accompanied by one of the shareholders when they used the facility.⁴² It can be concluded that more than fifty percent use by employees would be sufficient for the exception to apply.

Expenses Treated As Compensation

I.R.C. § 274(e)(2) provides an exception to the disallowance provisions of § 274(a) to the extent the taxpayer treats an expenditure for entertainment, or for use of a facility in connection therewith, as compensation to an employee who is a recipient of the entertainment.⁴³ The expenditure must be treated as compensation to the employee and as "wages to the employee for purposes of withholding."⁴⁴

³⁵ Treas. Reg. § 1.274-2(f)(2)(v) (as amended in 1985).

³⁶ *McReavy v. Commissioner*, 57 T.C.M. (CCH) 133, 133 (1989).

³⁷ *American Business Serv. Corp. v. Commissioner*, 93 T.C. 449, 461 (1989).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* at 460.

⁴¹ 57 T.C.M. (CCH) 133 (1989).

⁴² *Id.*

⁴³ I.R.C. § 274(e)(2) (1992).

⁴⁴ Treas. Reg. § 1.274-2(f)(2)(iii)(b) (as amended in 1985).

The current Corporation policy relies on this exception to obtain a deduction to the extent of the amount treated as compensation to employees. However, this is a limited exception. Corporation is still unable to deduct depreciation, repairs, and maintenance. The amount of those deductions is significantly greater than the amount of deduction for compensation to employees.

Entertainment Sold To Customers

Section 274(e)(8) provides an exception for "expenses 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."⁴⁵ Thus, the disallowance provisions would not apply to the condos if fair rental value were charged to all customers and all employees were charged with compensation.

Expenses Includible In Income Of Persons Who Are Not Employees

I.R.C. § 274(e)(9) provides an exception to the disallowance provisions of § 274(a) "to the extent that the expenses are includible in the gross income of a recipient of the entertainment . . . who is not an employee of the taxpayer as compensation for services rendered or as a prize or award under Section 74."⁴⁶

EXCEPTIONS APPLIED TO TUMMYACHE

The actual use of Tummyache is about sixty percent by customers and forty percent by employees. The usage percentages indicate that the § 274(e)(2) exception may not be a viable solution for Corporation unless a significant change is made to the policies concerning usage of the two condos. Section 274(e)(2) provides an exception to the extent expenditures are treated as compensation to employees.⁴⁷ The more significant deductions for depreciation, maintenance, and repairs are still not available.

Section 274(e)(9) also does not help Corporation. That section requires that a non-employee using the facility does so for services rendered or as a prize or award.⁴⁸

Section 274(e)(8) provides an exception to the disallowance provisions if the use of the facilities is provided in a bona fide transaction for full consideration.⁴⁹ With respect to Tummyache, Corporation would be able to use this exception if all customers using the condominium are required to pay fair rental value and all employees are charged with compensation. This exception is the most likely

⁴⁵ I.R.C. § 274(e)(8) (1992).

⁴⁶ I.R.C. § 274(e)(9) (1992).

⁴⁷ I.R.C. § 274(e)(2) (1992).

⁴⁸ I.R.C. § 274(e)(9) (1992).

⁴⁹ I.R.C. § 274(e)(8) (1992).

argument for deductibility of expenses in connection with Four Clovers. This is discussed in the next section.

Section 274(e)(4) provides an exception for recreational expenses "primarily for the benefit of employees."⁵⁰ If Corporation changed the policy concerning use of the condo, then Corporation could probably rely on the § 274(e)(4) exception to deduct all expenses with respect to Tummyache without having to charge customers fair rental value. The exception would not work for Four Clovers because the actual use is by a shareholder only.

The problem with the applicability of § 274(e)(4) is that the current actual usage of the condos is about sixty percent by customers and forty percent by employees. For the § 274(e)(4) exception to apply, the employee use should be more than fifty percent of the total use. Corporation would have to implement a policy whereby the usage percentages would change to favor employees other than those in the "restricted class"—shareholders, officers, and highly-compensated employees.⁵¹

If Corporation wants to rely on the § 274(e)(4) exception with respect to Tummyache, then permitting customers to use the condo should be limited. The § 274(a) disallowance is aimed at limiting the deductibility of entertainment for individuals in the restricted class *and* entertainment of customers by those individuals. Use by customers would weigh against a finding that the facility is primarily for the benefit of employees. Use by unrelated individuals should also be limited. Use by individuals other than employees would weigh against a finding that the facility is primarily for the benefit of employees.

The value of personal use of the condominiums would be a taxable fringe benefit to the employee.⁵² That means that the value of the personal use must be treated as compensation to the employee and as wages for purposes of withholding.⁵³

Substantiation of the actual use of the condominiums will be required.⁵⁴ A log should be kept showing the use of each condominium. The log should indicate the dates of any use of the facility, the purpose of the use, and the relationship of the person using the facility to the owner of the facility (Corporation). The form of the records should be a diary, log, or other systematic format.⁵⁵

⁵⁰ I.R.C. § 274(e)(4) (1992).

⁵¹ *Id.*

⁵² I.R.C. § 61(a)(1) (1992); Treas. Reg. § 1.61-21(a)(1) (1989). Fringe benefits are income subject to withholding unless excluded under § 132. *Id.* None of the § 132 exceptions applies here. *See* I.R.C. § 132 (1992).

⁵³ I.R.C. § 3402(a) (1992).

⁵⁴ I.R.C. § 274(d) (1992).

⁵⁵ Treas. Reg. § 1.274-5(c) (as amended in 1985).

A proposed policy for the Tummyache condo aimed at qualifying for the § 274(e)(4) exception for recreational use by employees is as follows:

**PROPOSED POLICY FOR USE OF THE TUMMYACHE
CONDOMINIUM (SO AS TO QUALIFY FOR THE § 274(e)(4)
EXCEPTION TO THE DISALLOWANCE RULES).**

Tummyache is to be held out primarily for the benefit of all of the employees of Corporation. In general, all employees are eligible to use the condominium for recreation. The actual usage of the condominium shall not discriminate in favor of officers, directors, shareholders, or highly-compensated employees.

Employees desiring to use the condominium shall submit a written request. Available usage dates shall be allocated on a first-come, first-served basis. An employee who is an officer, director, shareholder, or other highly-compensated employee shall not be able to preempt usage by another employee for a particular date.

The condominium may be made available to customers or prospective customers. However, such availability shall be limited. Total use by employees other than officers, directors, shareholders, or highly-compensated employees shall account for at least 51% of all use.

A record shall be kept with respect to the use of the condominium. The record shall indicate who used the facility, the dates of usage, the nature of usage, and the relationship between the user and Corporation.

CAN FOUR CLOVERS BE TREATED AS RENTAL PROPERTY?

Four Clovers As An Entertainment Facility

Even if Four Clovers is treated as rental property, deductions with respect to the condo may be disallowed by operation of § 274. Section 274 operates to disallow expenses in connection with an entertainment facility regardless of whether the expense would otherwise be allowed.⁵⁶ The condo may be a legitimate business rental property but expenses in connection with the condo will be disallowed under § 274 if the condo is an entertainment facility and no exception

⁵⁶ I.R.C. § 274(a)(1)(B) (1992).

applies.⁵⁷ This is true even if the expenses are otherwise deductible under § 162. To be deductible, an expenditure must satisfy the tests of both § 162 and § 274.⁵⁸

The key to determining whether Four Clovers can be excluded from the definition of "entertainment facility" is the term "entertainment." Regulation § 1.274-2(b) defines "entertainment." "The term 'entertainment' means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation."⁵⁹ The regulation notes that an activity may be entertainment even if the activity relates solely to the taxpayer or the taxpayer's family.⁶⁰ The term "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."⁶¹ The term "does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment."⁶² The examples given in the regulation show that the activities referred to that are not clearly entertainment are clearly business related.⁶³ The regulation notes that providing a hotel room to an employee while in business travel status would not be entertainment while providing a hotel room to an employee on vacation would be entertainment.⁶⁴

Four Clovers is used by Emma as a winter vacation home. Because the condo is a vacation home, is used for Emma's personal needs and has no clear business purpose, the condo falls within the "entertainment facility" definition. Treatment of the condo as rental property does not prevent the operation of the disallowance provisions of § 274.⁶⁵ It is thus necessary to find an exception to the disallowance provisions.

⁵⁷ Robert Zbacnik & Jim Ellerhorst, *supra* note 17, at 852.

⁵⁸ Cf. Treas. Reg. § 1.212-1 (as amended in 1975). Section 212 applies to individuals. The section provides that individuals may deduct expenses for the production of income. See I.R.C. § 212 (1992). Treas. Reg. § 1.212-1(h) (as amended in 1975) provides for the deduction of ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of real property held by the taxpayer as rental property. Treas. Reg. § 1.212-1(e) (as amended in 1975) notes that if an expense is disallowed by another Code section, then the expense cannot be deducted even though the expense is paid or incurred for a purpose identified in § 212. Thus, deductions with respect to rental property must meet the tests of § 212 and § 274. The § 274 rules governing deductions for such expenses are the same for business and non-business expenses.

⁵⁹ Treas. Reg. § 1.274-2(b)(1)(i) (as amended in 1985).

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* The regulation gives as examples: "(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." *Id.* (emphasis added).

⁶³ *Id.*

⁶⁴ Treas. Reg. § 1.274-2(b)(1)(i) (as amended in 1985).

⁶⁵ Treas. Reg. § 1.274-2(b)(2)(ii) (as amended in 1985) notes that any reference to "trade or business" in § 274 includes any rental activity described in § 212.

Applicable Exceptions

Section 274(e) provides exceptions to the disallowance provisions of § 274(a).⁶⁶ The best exception to rely on with respect to Four Clovers is § 274(e)(8), which provides an exception where the use of an entertainment facility is sold "in a bona fide transaction for adequate and full consideration."⁶⁷ However, the heading of the section--Entertainment sold to *customers*--and the regulations indicate that the use of the entertainment facility must be sold to a "customer."⁶⁸

The issue with respect to this exception becomes whether Emma is a "customer." The statute and regulations do not provide a definition of "customer" for purposes of this exception. However, the regulations indicate that "the cost of producing night club entertainment . . . for sale to customers" would come within this exception.⁶⁹

Emma can probably be considered a customer in the sense that she is a tenant of a corporate-owned rental property. Thus, arguably, Four Clovers falls within the § 274(e)(8) exception to the disallowance rules.⁷⁰

It is unclear whether the § 274(e)(8) exception is a limited one. The regulations use the language "*to the extent* the entertainment is sold."⁷¹ However, the "to the extent" language does not appear in the statutory language.⁷² Considering the examples provided in the regulations as falling within this exception (operating a pleasure cruise ship and producing night club entertainment), a limited exception does not make sense. It can be concluded that if a facility comes within the § 274(e)(8) exception, then all expenses in connection with the facility can be deducted.⁷³

⁶⁶ Treas. Reg. § 1.274-2(b) (as amended in 1985).

⁶⁷ I.R.C. § 274(e)(8) (1992).

⁶⁸ See Treas. Reg. § 1.274-2(f)(2)(ix) (as amended in 1985).

⁶⁹ *Id.*

⁷⁰ Section 274(e)(7) provides an exception for the use of facilities made available to the public. The exception does not apply to the Florida condo as Emma has year-round custody of the condo despite the fact she uses the condo for only part of the year. The condo is not held out to the public for the periods during which Emma does not occupy the condo.

⁷¹ Treas. Reg. § 1.274-2(f)(2)(ix) (as amended in 1985).

⁷² See I.R.C. § 274(e)(8) (1992).

⁷³ Arguments that the Florida condo is legitimate rental property would be strengthened by having Emma pay year-round rent.

Other Concerns

1. Section 280A

Section 280A disallows certain expenses in connection with rental of vacation homes if such homes are used during a tax year for personal purposes.⁷⁴ The statute applies only to individuals and S-corporations.⁷⁵ However, courts have applied the statute by analogy to corporate-owned rental property.⁷⁶ Thus, the section should be considered when planning treatment of Four Clovers.

The key to the limitations under § 280A is the taxpayer's personal use of the property.⁷⁷ If a unit is used solely as rental property and not used for *personal* purposes as a residence, then the rules under § 280A do not apply. Personal use includes use by any person who has an interest in the unit.⁷⁸ This would likely include a shareholder of a corporate taxpayer.⁷⁹

An exception to the "personal use" definition is provided in § 280A(d)(3). If a unit is rented to an "individual with an interest," then such use is not considered personal use if the rental is for a fair market rental and the rental unit is used as a "principal residence" by the individual living in the rental unit.⁸⁰ A principal residence is usually the home an individual lives in. If an individual has more than one home, then a facts and circumstances standard is applied to determine which home is the principal residence.⁸¹

If Emma's use is personal use for purposes of this section, then all expenses in connection with the condo would be disallowed because there would be no rental use of the unit.⁸² Emma's use of Four Clovers would probably be considered personal use because application of the facts and circumstances test would probably result in a determination that Four Clovers is not Emma's principal residence.

If this section were applied by analogy to the Corporation ownership of Four Clovers, then a disallowance might occur. However, the arguments under § 162 and § 274 are probably strong enough that a concern involving § 280A is unlikely to arise.

⁷⁴ See I.R.C. § 280A(a) (1992).

⁷⁵ *Id.*

⁷⁶ See *Edilberto Bertran v. Commissioner*, 43 T.C.M. (CCH) 892 (1982).

⁷⁷ I.R.C. § 280A(d)(1) (1992).

⁷⁸ I.R.C. § 280A(d)(2)(A) (1992).

⁷⁹ See I.R.C. § 267(c) (1992); see also I.R.C. § 280A(f)(2) (1992).

⁸⁰ I.R.C. § 280A(d)(3)(A) (1992).

⁸¹ See *Treas. Reg.* § 1.1034-1(c)(3) (as amended in 1979).

⁸² Section 280A does not operate to disallow deductions that are allowable without regard to any connection with an income-producing activity. If a unit was used for both personal use and rental or business use, then the deductibility of expenses would have to be determined by applying § 280A(d).

2. Section 162 and Section 183

Section 183 limits deductions to the extent of income if an activity is not engaged in for profit.⁸³ Section 183 applies only to individuals and S corporations.⁸⁴ However, courts have found the considerations concerning profit motive under § 183 instructive when deciding whether an expense is ordinary and necessary under § 162.⁸⁵

A taxpayer must engage in an activity with the predominant motive and intention of making a profit. The profit objective must be reasonable.⁸⁶ Considerations include profit motive, reasonableness of expense, whether the expense is incurred for a business purpose with intent to obtain a specific benefit, degree of personal use, and whether the business is operated in a businesslike manner.⁸⁷

The concern with respect to Four Clovers is the existence of a profit motive. Emma uses the condo for only part of the year and pays rent for only that period. The condo is not held out for rent during the periods when Emma does not occupy the condo. Even though Emma pays fair market rent, deductions of all expenses in connection with the condominium will result in a significant loss. This could result in a question as to the profit motive of Corporation in owning the condominium.

The profit motive is something that could be questioned and result in a failure to meet the ordinary and necessary standard of § 162. Arguments for full deductibility could be strengthened by either requiring Emma to pay year-round fair market rent or holding the condo out for rent to others during the periods that Emma is not using it.

CONCLUSION

The corporate-owned condominium as a combination business/entertainment site is no longer a simple way to deduct expenses for a corporate-owned condominium. Under the current interpretation of Internal Revenue Code § 274, if a facility is used even incidentally for entertainment, then all expenses with respect to the facility are disallowed. There are exceptions to the disallowance provisions. Most of the exceptions relate to use of such facilities for employees or for business facilities such as hotels. Section 274 accomplishes the mission of eliminating lavish entertainment at luxurious properties on pre-tax dollars.

⁸³ See *Bolton v. Commissioner*, 694 F.2d 556 n.14 (9th Cir. 1982).

⁸⁴ I.R.C. § 183(a) (1992).

⁸⁵ See *Edilberto R. Bertran v. Commissioner*, 43 T.C.M. (CCH) 892 (1982).

⁸⁶ *Id.* See also Treas. Reg. § 1.162-1 (1960).

⁸⁷ See Treas. Reg. § 1.162-1 (1960); I.R.C. § 183 (1992); *Edilberto R. Bertran*, 43 T.C.M. (CCH) 892.

