Office of Chief Counsel
Internal Revenue Service

Memorandum

Number: **20115002F**
Release Date: 12/16/2011

CC:LM:RFPH:CHI:2:M:POSTF-130690-11

date: September 27, 2011

to: Revenue Agent (LB&I), Waukesha

from: Associate Area Counsel (LB&I), Chicago

subject: **Deduction for Cost of to**

***** Taxpayer**

This memorandum is in response to your request for advice in the examination of *** Taxpayer for the tax years ended *** a through *** b. At issue is whether the taxpayer can deduct the to *** c by major shareholders to recover a . In our opinion, the costs are not deductible on the corporate return.

This memorandum was coordinated with the National Office, Associate Chief Counsel for Income Tax and Accounting, Branch 2. This advice may not be used or cited as precedent.

<u>Legend</u>

Taxpayer =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

r =

s =

t =

u =

v =

w =

x =

y =

z =

aa =

ab =

ac =

ad =

ae =

af =

ag =

ah =

ai =

aj =

ak =

al =

am =

an =

ao =

ap =

Facts

*** Taxpayer (hereinafter “the taxpayer” or “the company”) is a major manufacturer of *** d. The company was founded in *** e as *** f and, by the , was a successful manufacturer of *** g, with subsidiaries in *** h, *** i, and *** j.

In the president and principal stockholder, *** k, led an to the *** l area of *** m in search of a reliable supply of *** n. *** n was, at that time, *** o and was derived from *** p. The company purchased a *** q for the . The was successful and the company established a in *** m. In , the was sold to *** r, which used it for an to *** c, where the .

In , *** s, son of *** k and the principal shareholder of the company, and his two sons, *** t and *** u of the *** q to *** m in a of the . The expenses of the trip were currently deducted on the corporate return and the costs of building the and of making a *** v were capitalized and depreciated. The Service did not challenge this treatment. The company displayed the in the *** w's in *** x, along with an exhibit describing the original and the commemorative . The was not donated to the *** w; the and the exhibit were later transferred to the taxpayer's at its headquarters campus. The company is not an organization exempt from tax under I.R.C. §§ 501(a) and 501(c)(3).

Also in fiscal year , *** s led an to *** c to locate the remains of the original . The was not successful. The cost of this was deducted on the corporate return for . Upon examination, the Service did not challenge this deduction.

*** s was described by *** y in as *** z. His donations to the *** aa, the *** ab, and *** ac are legendary. *** v was favorably reviewed by *** ad, which called it *** ae. The has been for invited audiences, at , and on the *** af *** ag.

*** k died in ; *** s died in 4. *** s's sons *** t and *** u are currently major shareholders in the company. *** s is chairman and chief executive officer of the company. The company is ; all shares are owned by members of the *** ah family or by family trusts.

In fiscal year , *** t, *** u, and several family members travelled to *** c after hearing rumors that the *** q had been located in a different area than previously suspected. The found and positively identified the and investigated the possibility of , returning it to the , and displaying it in the company . Expenses were incurred for travel, rental, , , security, public relations, and related items. Filming costs totaled approximately $ and travel costs were calculated at approximately $. Some $ was paid to experts at *** ai for a study on recovering and transporting the . The company eventually decided not to remove the and a was erected at the site.

An exhibit at the company *** aj displays photographs, video, and artifacts of the , along with the reproduction and displays describing the original and commemorative to *** m. The taxpayer states that the original and are "company icons holding particular significance to [the company], company employees and the surrounding community" and are "vital elements of [the company's] culture" that "enhance and create opportunities for [the company] to tell its story and promote the company." The was mentioned in the company's "public report" but, as the company is , the extent to which this report is distributed is not clear.

The company deducted the above-mentioned costs of the *** ak on its tax return for fiscal year . Travel costs of $ for the widow of *** s, two of her grandsons, and *** t were paid for by the *** ah family and were not deducted by the corporation.

Currently, the corporate returns for the years ended *** a through *** b are under examination. At issue is whether the costs of the *** al of (fiscal year) (hereinafter "the *** al ") are deductible.

Issue

Are the costs of an , led by a corporate president/shareholder, to recover the remains of an prominent in the history of the corporation deductible on the corporate return?

Law

I.R.C. § 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

Reg. § 1.162-2 allows a taxpayer to deducted travel expenses that are "reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it." It further states that "if the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses . . ."

"Necessary," as it is used in § 162(a), means that the expense is appropriate and helpful, rather than absolutely essential. Welch v. Helvering, 290 U.S. 111, 113 (1933). But if there are other, more economical and practical means of attaining a result, the expense is not reasonable and, therefore, not necessary. A.S. Barber, Inc. v. United States, 85-1 USTC P 9138 (D. Mo. 1984); Sherman v. Commissioner, 44 TCM 1324, 1326 (1982); Ciaravella v. Commissioner, T.C. Memo. 1998-31. Under Reg. § 1.162-1(a), a corporation may deduct expenses for advertising and promotion. In determining the extent to which advertising expenses are reasonable, the court will compare the amount expended for the activity in question with the amount of benefit reasonably expected to be derived. Ciaravella v. Commissioner, T.C. Memo. 1998-31; Mathes v. Commissioner, T.C. Memo. 1990-483.

An expenditure that benefits employees in a private setting does not promote or advertise the taxpayer's business to the world of customers and is therefore not deductible. Quarrier Diner, Inc. v. Commissioner, 22 TCM 276, 279 (1963). The advertising must be directed toward those constituting the taxpayer's market or business environment. U.S. Equipment Co. v. Commissioner, 22 TCM 1309, 1321 (1963). The lack of exposure to groups from whom the taxpayer's business contacts or customers are likely to emerge precludes deduction of the expense. W.D. Gale, Inc. v. Commissioner, 297 F.2d 270, 271 (6th Cir. 1961).

The payment by one taxpayer of an expense of another taxpayer's trade or business is not deductible. Deputy v. DuPont, 308 U.S. 488, 494 (1940). As a general rule, the trade or business of a corporation is not also a trade or business of its share-holders. Whipple v.

Commissioner, 373 U.S. 193, 202 (1963).

I.R.C. § 262(a) states that "except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

I.R.C. § 170(a) allows as a deduction "any charitable contribution . . . payment of which is made within the taxable year." Under § 170(b)(2), in the case of a taxpayer-corporation, the deduction "shall not exceed 10 percent of the taxpayer's taxable income." Under § 170(c), in order to be deductible, the contribution must be made to certain units of government, or to organizations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals, provided the organization is not disqualified under § 501(c)(3).

Analysis

In our opinion, the expenditures at issue are not deductible by the taxpayer as they are not ordinary and necessary expenses of the taxpayer's trade or business. In order for an expenditure to be deductible as advertising, the taxpayer has the burden of proving a proximate relationship between the expenditure and the corporation's business, that the activity "was reasonably calculated to call public attention to its business in some manner that might reasonably be expected to produce some patronage benefit," and that the expenditure was reasonable in amount compared to the reasonably expected benefits. W.D. Gale v. Commissioner, T.C. Memo. 1960-191.

For example, in W.D. Gale v. Commissioner, T.C. Memo. 1960-191, the principal shareholder of an electrical contracting business was prominent in motor boat racing. The expenses of that activity were held not deductible by the corporation as the corporation was rarely mentioned in connection with the activity and, therefore, the business "received no substantial publicity" from the racing program.

Similarly, in Sieber v. Commissioner, T.C. Memo. 1979-15, the taxpayer claimed that his polo-playing activities were expenditures for the advertising and promotion of his building construction business. The court stated that

> Petitioner has the burden of proof that his costs of playing polo were ordinary and necessary expenses of that business under section 162. To carry his burden, it is incumbent upon petitioner to show affirmatively that the expenditures were undertaken primarily for a business, not a social or personal, purpose and that there was a proximate, rather than merely a remote or incidental, relationship between the expenditures and petitioner's business -- essentially a question of fact. His burden is not made easier by the fact that the expenses involved are of a character which are normally

> personal and, therefore, may fall within the ambit of section 262, which takes precedence over section 162. We conclude that petitioner has not carried his burden of proof. The weight of the evidence strongly suggests that petitioner played polo primarily because it gave him personal satisfaction and helped him maintain a close relationship with his family. [citations omitted.]

As the court stated in Mathes v. Commissioner, T.C. Memo. 1990-483,

> Section 162(a) is not a carte blanche grant by the Government for the right to deduct all expenses which arguably are somewhat related to an income-producing activity, no matter how unreasonable in amount. The element of reasonableness is inherent in the phrase “ordinary and necessary” . . . whether the amount of the deduction claimed is reasonable is determined under the facts and circumstances of each case. The burden of proving that such amounts are reasonable rests with petitioner. In determining whether the amount expended is reasonable, the amount of the expenditure has been compared with the benefit to be derived. [citations omitted.]

Admittedly, it is not for the Service to decide whether a taxpayer’s expenditure is the best possible use of the company’s funds, only whether it was ordinary and necessary in pursuit of the business. Expenditures for advertising are deductible whether or not the advertising is effective; they are even deductible if the advertising completely misfires and has disastrous results for the company’s sales and reputation. The deduction depends primarily on whether the expenditure, at the time it was authorized, “might reasonably be expected to produce some patronage benefit.” On the other hand, the expenditure cannot have merely a remote or tangential connection with promoting the company; and the expense must be reasonable in amount compared to the reasonably expected benefits. Extravagant expenditures from which a reasonable person could expect only minimal benefits are not deductible. As the court stated in Helstoski v. Commissioner, T.C. Memo. 1990-382:

> We do not intend to suggest that we should, as a matter of course, second-guess taxpayers' business decisions or restrict taxpayers to deduction of only the least expensive method of conducting their businesses. Nevertheless, when the individuals involved are major owners and ranking officers of the business in question, and when the issue is whether the travel expenses were primarily the personal expenses of those controlling individuals or primarily business expenses, one factor that may bear upon that issue is whether there are less expensive alternatives that would have been practical ways to conduct the business activities without so much, or so costly, travel.

In your examination, the taxpayer has not demonstrated that the *** al was intended to benefit the reputation or increase the sales of the corporation. It has not demonstrated that the results of the were disclosed to customers or potential customers (or were intended to be so disclosed) in any manner beyond the exhibit, public report, and perhaps some other minimal publications. It has not proven that the large expenses of the were reasonable in relation to the corporate benefits that could reasonably be expected.

We note also that, even if it could be established that the improved the reputation and goodwill of the *** ah family, such an accomplishment is not necessarily a promotion of the corporation itself and thus not deductible by the corporation. Brown v. Commissioner, T.C. Memo. 1970-253. Only the promotion of the company and its products qualify for deduction under § 162(a). The company has attempted to link the two, stating that the company:

> projects an image of a unique family culture founded on principles and values . . . [that] the *** aj represents the spirit of family, the spirit of adventure, and the spirit of leadership—- all values that are part of who we are as a company . . . it highlights *** Taxpayer’s family company message and celebrates its history . . . *** Taxpayer has qualified research showing that consumers would rather buy from a family-owned business. . . .
>
> Creating an environment where emotional connections with the *** ah family and a sense of pride among employees are also very helpful in creating a stronger, more vibrant company.

We believe that any promotion of the good reputation of the *** ah family that may have resulted from the *** al is too remote from the promotion of the company and its products to qualify as a corporate advertising deduction.

The taxpayer has referred to Poletti v. Commissioner, 330 F.2d 818 (8th Cir. 1964), in support of its deduction. In that case, the taxpayer ran an employment agency and gave free gifts, both to individuals who sought placement through the agency and to companies where it placed employees. The court held such expenditures deductible, noting that a taxpayer “should not be penalized taxwise for business ingenuity in utilizing advertising techniques which do not conform to the practices of one whom he is naturally trying to surpass in profits.”

Though this precedent no doubt endorses creativity in advertising, we do not believe it supports the deduction at issue. Unlike Poletti, where it was obvious that the expenditure, though unconventional, benefitted the company, the taxpayer here has not proven that the expenditure resulted in any useful promotional communication to potential customers, or was intended to do so, at least not on a scale commensurate to the size of the expenditure.

Furthermore, the elements of personal pleasure cannot be ignored. Although we do not doubt that the *** al had some historic element, the photographs and descriptions of the , as provided to the Service by the taxpayer, indicate that the president of the company, his mother, and other relatives enjoyed many recreational amenities on this , including diving, sailing, swimming, and other diversions. As numerous judicial opinions indicate, these factors weigh in favor of a finding that the expenses are non-deductible as “personal, living, or family expenses” under § 262 and against a finding of a business purpose under § 162(a). The fact that the expenses of five[1] family members who travelled on the expedition were not deducted on the corporate return suggests that the expedition was primarily a family recreational event and not primarily business-related.

The Regulations under § 162 envision three types of travel: (1) “Solely on business,” in which case all reasonable and necessary travel expenses, including meals and lodging, are deductible (Reg. § 1.162-2(a)); (2) travel that mixes personal and business, in which case the expenses of travel to the destination are deductible if the trip is “primarily” for business (Reg. § 1.162-2(b)(1)); and (3) travel “primarily personal in nature”, in which case the “traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination” but “expenses while at the destination which are properly allocable to the taxpayer’s trade or business are deductible” (Reg. § 1.162-2(b)(1)). In your examination the *** al expedition appears to be primarily personal. The company has not established (and cannot establish) that any part of the expenses are business, because the only potentially business-related activity would be advertising-related which (as explained above) is too insufficient to qualify as ordinary and necessary.

As we do not believe the expenditures qualify under § 162, we do not reach the issue of whether they would be capitalized and amortized (rather than deducted currently) as discussed in Reg. § 1.162-20(a).

Neither are the expenses deductible as a charitable contribution. Although a small documenting the *** al was placed in the taxpayer’s , that is not a tax-exempt entity as defined in I.R.C. §§ 170 and 501(c)(3). In connection with the *** al , no cash or other thing of value was transferred to a tax-exempt entity, nor did the company pay any expenses that were the legal obligation of a tax-exempt entity. A charitable contribution deduction is thus not an appropriate alternative.

As you have noted, the Service examined this taxpayer in previous years and did not disallow deductions arising from a previous (in) for the . We note that, as a matter of law, the Service is not required to treat a taxpayer consistently from year to year; the fact that the Service allows a deduction in one year does not bar the Service from disallowing a similar deduction in a later year. Each year stands on its own. United States v. Skelly Oil Co., 394 U.S. 678, 684 (1969); Knights of Columbus Council #3660 v. United States, 783 F.2d 69 (7th Cir 1986); Rose v. Commissioner, 55 T.C. 28, 32 (1970); Rooney v. Commissioner, T.C. Memo. 2011-14. Even if justification were needed for treating the two years differently, there may be factual distinctions between the

[1] *** am, *** at, *** an, *** ao, and *** ap.

two which justify the deduction of one but not the other. For example, the earlier is included in the *** v which may be of legitimate advertising value; the second took place after the making of the and does not appear to have been given any significant exposure to the public. The first may have lacked the family vacation factors prominent in the second . It is also possible that the earlier deduction simply escaped the Service's attention, or the amount was deemed insignificant, or the pursuit of a deficiency was judged to be an unjustified use of the Service's limited resources. Of course, we cannot now (on the grounds of consistency) disallow the deduction, as the statute of limitations on assessment has expired for that fiscal year. But the Service need not allow a similar deduction in on the grounds of consistency.

Consistency objections could also be raised due to the Service disallowing the costs of the *** al of while allowing other contributions to or expenses of the company in that year. Again, we note that the Service is not obliged to disallow every deduction that could conceivably be challenged; the Service can allow some questionable deductions while disallowing others. In this case, the Service does not choose to question whether the entire and all of its costs are defensible as an advertising and promotional expense in the years under examination. The taxpayer states (without citation to any authority) that the deduction of the costs of company on the grounds that they promote the company and its products is not unheard of. It is entirely possible that the taxpayer in this case can justify and substantiate that the in general (and the *** v are legitimate advertising expenses; we maintain, however, that the taxpayer has not proven that the costs of the were primarily business rather than personal under §§ 162(a) and 262, and that the resulted in any useful promotional communication to potential customers, or was intended to do so, at least not on a scale commensurate to the size of the .

Of course, consistent with the expense not being deductible on the corporate return, that part of the cost of the which is a personal benefit to the president of the company is income to him not reported on his return. It is at the discretion of the Compliance Division, however, whether an examination of the president's individual return should be opened and an adjustment proposed; this decision involves matters regarding the allocation of IRS time and resources that are beyond the scope of Counsel's knowledge and authority.

Conclusion

We conclude that there is no legal basis for deducting the costs of the fiscal year to locate the of the .

If you have any questions, please contact the undersigned at 414-231-2807.

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By: ______________________________

Attorney