Current Federal Tax Developments

Week of May 10, 2021

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SECTION: 62
IRS MEMORANDUM DISCUSSES DEDUCTION OF AIRCRAFT EXPENSES BY A SOLE PROPRIETOR

Citation: CCA 202117012, 4/30/21

In Chief Counsel Advice 202117012[1] the IRS looks at issues surrounding the deduction of expenses related to the use of aircraft by a sole proprietor. Specifically, the ruling looks at whether the taxpayer uses:

- The primary purpose test found at Reg. §1.62-2(b) or
- The allocation methods found at Reg. §1.274-10(e)

Primary Purpose Test for Travel Expenses (Reg. §1.162-2(b))

The primary purpose test for travel expenses of a taxpayer is found at Reg. §1.162-2(b)(1) which provides:

> (1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.[2]

Reg. §1.62-2(b)-2(b)(2) notes that the test is based on facts and circumstances, but that the amount of time spent on each type of activity is a key item to be considered:

> (2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation

[1] CCA 202117012, April 30, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/irs-allows-primary-purpose-test-for-deducting-aircraft-expenses/59pgm (retrieved May 9, 2021)

[2] Reg. §1.162-2(b)

> or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

So, for example, if someone who works as a CPE instructor (such as I do) flies to a city to give a CPE session, we look to see if the primary purpose of the trip is for business to determine if the travel costs will be deductible. Normally the answer will be yes, as I would have traveled to the city at the request of a customer located in that city. Normally I would be in the city only for the days when I am presenting a session, and only incidentally would I spend time on personal pursuits.

But if I was heading to a city for a major family event, spending two weeks with family, managing to arrange to give a one-day CPE session while in that location would not make the travel deductible except for expenses directly related to that one day continuing education session. Such costs would be those costs I would not have incurred on the trip but for giving that CPE session.

As always, the burden would be on the taxpayer to show that business motivations were the primary reason for the trip or, if that could not be shown, what expenses incurred on the trip were related to business activities.

The memorandum discusses the *Bruns* case to show how courts have applied this test:

> In *Bruns v. Commissioner*, T.C. Memo. 2009-168, 2009 WL 2030886, at *11–*12 (July 14, 2009), the taxpayer claimed deductions for travel expenses related to trips having a mixed business and pleasure motivation. The court noted that on these trips, taxpayer visited friends and relatives who were also customers and distributors in the taxpayer's business. Updating these customers and distributors about the new products and providing coaching on business leadership was business related. Visiting with friends and relatives about matters not related to the business was for pleasure. The court cited § 1.162-2(b)(1), (2) and (c), explaining that petitioners would be entitled to a deduction for expenses incurred at the location properly allocable to business activities. However, petitioners failed to provide sufficient information to allow any of the disallowed travel expenses.[3]

Special Rules for Aircraft Used as Entertainment (Reg. §1.274-10)

IRC §274(a) disallows any deduction for expenses related to an entertainment facility. Aircraft is subject to special limitations described at Reg. §1.274-10.

Certain exceptions to the bar on deductions related to entertainment facilities are described by the memorandum:

> Section 274(e)(2)(A) excepts expenses for goods, services, and facilities for entertainment from the § 274(a) disallowance to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, as compensation to the employee on the taxpayer's returns and as wages to such employee for purposes of chapter 24

[3] CCA 202117012, April 30, 2021

> (withholding of income tax at source on wages). Section 274(e)(9) similarly excepts expenses 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.
>
> Section 274(e)(2)(B) provides that in the case of a "specified individual," the §274(e)(2)(A) and (9) exceptions to the § 274(a) disallowance apply only to the extent that the expenses do not exceed the amount of expenses that are treated as compensation to the specified individual.[4]

Thus, under this exception a deduction could be allowed for entertainment use of the airplane so long as the expenses were includable in the compensation of an employee as additional wages or as a payment for services to a non-employee.

If that person is a "specified person" (roughly those in a position of control of the business) the deduction is limited to the amount included in the compensation of the individual. This rule was enacted due to taxpayers noting that the rules on valuing such flights for the service provider often resulted in amounts of compensation being taxed to the provider that was far less than the allocable cost of providing the service to the individual.

The CCA goes on to explain the regulation relating to entertainment use of an aircraft as follows:

> Section 1.274-10(a)(1) provides that no deduction otherwise allowed under Chapter 1 is allowed for expenses for the use of a taxpayer-provided aircraft for entertainment, except as provided in § 1.274-10(a)(2).
>
> Sections 1.274-10(a)(2)(ii)(A) through (C) provide exceptions to the disallowance of expenses for entertainment air travel for expenses treated as compensation to employees who are not specified individuals, non-employees who are not specified individuals, and specified individuals, respectively.
>
> Section 1.274-10(e) provides rules for allocating expenses between the various individuals present on a flight with a specified individual and the character of each passenger's use of the aircraft.[5]

In this situation, a business could claim a deduction for expenses related to operating the aircraft, even if for entertainment purposes (such as taking a purely personal trip that had no business connections), so long as the service provider picked up income. If that service provider was a specified individual, then the deduction would be limited to the amount of income recognized by the service provider.

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[4] CCA 202117012, April 30, 2021

[5] CCA 202117012, April 30, 2021

Application to Self-Employed Individuals

The CCA looks at the following situation.

> Taxpayer is a sole proprietor and a Schedule C business owner who wholly owns and operates a business in either: (i) his or her own personal capacity, or (ii) through a single-member LLC which is disregarded as an entity separate from its owner for federal income tax purposes. The sole proprietor owns an aircraft either directly or indirectly through a single-member LLC and uses the aircraft to travel for business and entertainment purposes. Family members, friends, and business associates of the sole proprietor regularly travel with the sole proprietor on the aircraft.[6]

So now the question is simply this: in deciding about deducting expenses related to this aircraft, does the proprietor simply apply the primary purpose test to the operation of the aircraft as a travel expense, or do we look to the allocations under the special rules in Reg. §1.274-10 for entertainment use of an aircraft?

The CCA determines that only the primary purpose test for travel expenses apply to the sole proprietor, though if others on the plane are using it for entertainment operating costs may still be partially disallowed due to the entertainment deduction limitations.

First, the IRS notes that the proprietor is not an employee, so the rules related to an employee cannot be applied:

> The exceptions to the disallowance of entertainment expenses in § 274(a) for expenses treated as compensation in § 274(e)(2) and (9) do not apply to a sole proprietor. In relevant part, § 274(e)(2) applies to the use of entertainment facilities by an employee of the taxpayer. A sole proprietor is not an employee of the sole proprietorship under the usual common law rules and does not receive compensation and wages from the sole proprietorship; rather, the sole proprietor is a self-employed individual for federal income tax purposes, and directly earns income from operating the business as an individual.
>
> The use by a sole proprietor of an aircraft owned by the sole proprietor (directly or in a disregarded entity), whether for business or personal/entertainment use, does not result in compensation or imputed income, and cannot be reported as wages or as income. Hence, the exception from § 274(a) under § 274(e)(2) cannot apply to a sole proprietor.[7]

[6] CCA 202117012, April 30, 2021

[7] CCA 202117012, April 30, 2021

The CCA also concludes that the second category related to a person who is not an employee cannot apply because the proprietor can't end up recognizing income from the use of an aircraft the proprietor owns:

> Similarly, for purposes of § 274(e)(9), while the sole proprietor is a person "who is not an employee," the use of the sole proprietor's own aircraft by the sole proprietor is not "includible in the gross income of the (sole proprietor) recipient" as compensation or as a prize or award by the sole proprietorship. Therefore, the exception to § 274(a) under §274(e)(9) cannot apply to the sole proprietor's use of the aircraft.
>
> Because § 274(e)(2) and (9) do not apply to a sole proprietor, the allocation rules of §1.274-10 promulgated thereunder have no application, and arguments concerning whether the taxpayer is or is not a specified individual are not relevant for these purposes.[8]

The last sentence of this part of the analysis may give a clue regarding why this CCA was issued. Presumably, some might try and argue that a sole proprietor is not a specified individual, thus we could have a situation where the proprietor recognized income on the value of the trip that is far less than the costs incurred for operating the aircraft for the non-business trip.

The memorandum concludes that the issues related to use of the aircraft of the sole proprietor must be viewed through the travel rules found in Reg. §1.62-2, concentrating on the primary purpose of the trip:

> Expenses for use by a sole proprietor of an aircraft owned by the sole proprietor may be deductible under § 162 based on the primary purpose test. If the primary purpose of a flight is personal rather than business, the expenses for the flight are not expenses paid or incurred in pursuit of the taxpayer's trade or business under § 162(a) and are nondeductible pursuant to § 262(a). The determination as to whether a mixed-use flight is a deductible business flight or a non-deductible personal flight is a facts and circumstances determination made under § 162 and the related regulations and case law.[9]

However, this does not allow the proprietor to deduct all expenses if other individuals accompany the proprietor on the flight. Rather, the CCA argues, the proprietor must make a reasonable allocation between business use and nondeductible entertainment use for potentially deductible items related to the aircraft.

> Limitations for entertainment expenses may apply to deductions for the use by a sole proprietor of an aircraft owned by the sole proprietor. An allocation between business use and nondeductible entertainment use of an aircraft must be made using a reasonable method when deducting expenses, including depreciation, for a flight if any person on the flight engaged in entertainment activities during

[8] CCA 202117012, April 30, 2021

[9] CCA 202117012, April 30, 2021

> the associated trip. The primary purpose test is not applicable to this analysis and is not a reasonable method for this purpose.

This means that other persons can't "tag along" with the proprietor on a business flight by simply testing to see if the proprietor meets the primary test for the trip to get a full deduction for all expenses—rather the entertainment use of the aircraft by those other individuals may jeopardize a portion of the deduction.

> This allocation is required because § 274(a): (i) limits deductions for business entertainment use of an aircraft for amounts paid or incurred prior to January 1, 2018, (ii) disallows deductions for non-business entertainment use of an aircraft for amounts paid or incurred prior to January 1, 2018, and (ii) disallows deductions for any entertainment use of an aircraft for amounts paid or incurred after December 31, 2017. Deductions for the portion of the flight allocable to persons accompanying the sole proprietor may be further reduced under § 274(m)(3) and § 1.162-2(c).[10]

SECTION: 1411
DIVIDENDS RECEIVED BY AN EMPLOYEE OF A CORPORATION ARE STILL PART OF NET INVESTMENT INCOME

Citation: CCA 202118009, 5/7/21

In Chief Counsel Advice 202118009[11] the IRS addresses the question of whether tax dividends received by a shareholder who is also employed by the C corporation is subject to the net investment income tax, as well as if the answer changes if the corporation is closely held.

Net Investment Income Under IRC §1411

The Affordable Care Act added IRC §1411 which imposes a tax on the lesser of the net investment income of a taxpayer or the taxpayer's adjusted gross income in excess of threshold amounts that vary by filing status.

Under IRC §1411(c)(1), *net investment income* includes gross income from dividends other than those that are derived in the ordinary course of a trade or business.

The advice looks at the following situation:

> The Taxpayer is a shareholder in a C corporation. It was determined under examination that the corporation paid Taxpayer's personal

[10] CCA 202117012, April 30, 2021

[11] CCA 202118009, May 7, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/shareholder%25e2%2580%2599s-income-from-closely-held-c-corp-subject-to-nii/5jwrz (retrieved May 7, 2021)

> expenses from corporate accounts, and the payments were reclassified as dividend income paid to the Taxpayer by the corporation. The Taxpayer is also an employee of the corporation and is involved in the day-to-day operations of the corporation's manufacturing trade or business. The facts further indicate that the corporation may be a closely-held corporation within the meaning of § 469(h)(1) as described in § 465(a)(1)(B) (the Taxpayer appears to own a majority of the shares of the corporation). The Taxpayer contends that because the Taxpayer materially participates in the manufacturing trade or business of the corporation as an employee, the dividend income that the Taxpayer received from the corporation is not subject to tax under § 1411, because the dividend income is derived in the ordinary course of a trade or business that is not a passive activity of the Taxpayer within the meaning of § 469.[12]

So, is the taxpayer correct in his view that being involved in day to day operations of the corporation removes the dividend income from the investment income category found at IRC §1411(c)(1)? Or do the dividends retain their status as investment income, and are not considered derived in the ordinary course of a trade or business?

Employment Does Not Change the Nature of the Dividends

The IRS's conclusion is that these dividends retain their status as part of investment income.

Since dividends are defined by statute as part of investment income unless derived in the ordinary course of a trade or business, the CCA looks at the regulations that define this concept:

> To qualify for the "ordinary course of a trade or business" exception, § 1.1411-4(b) provides that the dividend income must be derived in a trade or business conducted (1) directly by the taxpayer (or through a disregarded entity owned by the taxpayer), or (2) through a passthrough entity (partnership or S corporation). Since a C corporation is not a passthrough entity and is also not a disregarded entity, dividend income received by a C corporation shareholder generally cannot satisfy the "ordinary course of trade or business" exception in § 1.1411-4(b). (emphasis added)[13]

The memo then looks at the specific case of when dividends are deemed received in the ordinary course of a trade or business, which the CCA provides would only be the case if the taxpayer were a dealer or trader in stock or securities—not merely an employee of the corporation that issued the stock:

> C corporation stock generally produces dividend income to its shareholders and the stock is generally treated as property held for investment for purposes of § 469(e)(1)(A) and § 1.469-2T(c)(3), unless the dividends are derived in the ordinary course of a trade or business.

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[12] CCA 202118009, May 7, 2021

[13] CCA 202118009, May 7, 2021

> Under these rules, any dividend income paid by a C corporation would not be derived by a shareholder in the ordinary course of a trade or business unless the shareholder is a dealer or a trader in stock or securities. Being a shareholder in a C corporation in and of itself is not a trade or business that would cause the dividend income received by the shareholder from the C corporation to be properly treated as derived in the ordinary course of a trade or business.[14]

The CCA rejects the taxpayer's argument that employment by the corporation changes the treatment of the dividends:

> In this case, Taxpayer holds C corporation stock and has not shown that the dividends were received in the ordinary course of the Taxpayer's trade or business. Rather, Taxpayer argues that participating in the C corporation's business as an employee is sufficient to meet the exception in § 1411(c)(1)(A)(i). Taxpayer's involvement in the C corporation's trade or business is not relevant.[15]

Essentially, the IRS views the taxpayer as receiving that dividend not due to being an employee of the corporation, but rather related to being an investor in the corporation.

Closely Held Corporations

But is the rule different for a closely-held C corporation? Should a 100% shareholder in a small manufacturing concern be looked at differently in this regard than an employee of Microsoft that happens to have purchased some shares of his/her employer on the open market?

The CCA answers that question with a clear no.

> As discussed above, § 1.1411-4(b) does not provide any rules for determining whether gross income derived by a shareholder of a C corporation (including a closely held C corporation) may be properly treated as derived in the ordinary course of a trade or business. C Corporations, including closely held C corporations, are not passthrough entities. This analysis and conclusion do not change simply because a shareholder may be treated as materially participating, for purposes of § 469, in a trade or business activity conducted through a closely held C corporation.[16]

What if This Had Been an S Corporation?

The CCA's analysis looks at the situation for a C corporation. But S corporations are far more common for small, closely held corporations. What changes in that situation?

Likely nothing if the shareholder receives a distribution that is treated as coming out of earnings and profits of the S corporation—that is just as much a tax dividend as if it

[14] CCA 202118009, May 7, 2021

[15] CCA 202118009, May 7, 2021

[16] CCA 202118009, May 7, 2021

had come from the C corporation. And such a distribution would end up in investment income under the analysis found in the CAA.

The more normal case of distributions from the S corporation that come from accumulated earnings and profits are not considered taxable dividends for income tax purposes, and thus are not in the list of investment income found in IRC §1411.

Flow through income from the K-1 retains its status as trade or business income, and thus only runs afoul of the net investment income tax if the trade or business is a passive activity with regard to the taxpayer or it is a trade or business of trading in financial instruments or commodities.[17]

SECTION: ENFORCEMENT
IRS GRANTED PERMISSION TO SERVE JOHN DOE SUMMONS FOR TRANSACTION INFORMATION FROM KRAKEN CRYPTOCURRENCY EXCHANGE

Citation: In re Tax Liabilities of John Does, US District Court, Northern District of California, Case No. 3:21-cv-02201, 5/5/21

The IRS won a victory in its attempt to obtain information related to virtual currency transactions from exchanges in the case of *In re Tax Liabilities of John Does*.[18]

The IRS has sought to serve a "John Doe" summons to Payward Ventures Inc. d/b/a/ Kraken and its subsidiaries for information related to customers of the exchange. The Court initially balked at the request, asking the IRS to show cause why the petition to serve the summons should not be denied for being overly broad.[19]

The IRS responded by narrowing the scope of the request and providing additional information to justify the items remaining as requested information. The Court allowed the IRS to move forward at this point to serve the summons, though the exchange or customers are still allowed to file additional arguments regarding the validity of the request.[20]

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[17] IRC §1411(c)(2)

[18] *In re Tax Liabilities of John Does*, US District Court, Northern District of California, Case No. 3:21-cv-02201, May 5, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/irs-can-serve-john-doe-summons-on-kraken-crypto-exchange/5jwk6 (retrieved May 9, 2021)

[19] *In re Tax Liabilities of John Does*, US District Court, Northern District of California, Case No. 3:21-cv-02201, May 5, 2021

[20] *In re Tax Liabilities of John Does*, US District Court, Northern District of California, Case No. 3:21-cv-02201, May 5, 2021

While the decision published by the Court was short on details, the U.S. Department of Justice published a news release that did give more details on what was being requested.[21] The release stated:

> A federal court in the Northern District of California entered an order today authorizing the IRS to serve a John Doe summons on Payward Ventures Inc., and Subsidiaries d/b/a Kraken (Kraken) seeking information about U.S. taxpayers who conducted at least the equivalent of $20,000 in transactions in cryptocurrency during the years 2016 to 2020. The IRS is seeking the records of Americans who engaged in business with or through Kraken, a digital currency exchanger headquartered in San Francisco, California.
>
> …
>
> Today's order from the Northern District of California grants the IRS permission to serve what is known as a "John Doe" summons on Kraken. The United States' petition does not allege that Kraken has engaged in any wrongdoing in connection with its digital currency exchange business. Rather, according to the court's order, the summons seeks information related to the IRS's "investigation of an ascertainable group or class of persons" that the IRS has reasonable basis to believe "may have failed to comply with internal revenue laws." According to the copy of the summons filed with the petition, the IRS directed Kraken to produce records identifying the U.S. taxpayers described above, along with other documents relating to their cryptocurrency transactions.[22]

[21] "Court Authorizes Service of John Doe Summons Seeking Identities of U.S. Taxpayers Who Have Used Cryptocurrency," Department of Justice News Release, May 5, 2021, https://www.justice.gov/opa/pr/court-authorizes-service-john-doe-summons-seeking-identities-us-taxpayers-who-have-used-1 (retrieved May 9, 2021)

[22] "Court Authorizes Service of John Doe Summons Seeking Identities of U.S. Taxpayers Who Have Used Cryptocurrency," Department of Justice News Release, May 5, 2021