Land & Water Law Review

Volume 3 | Issue 1 Article 14

1968

Federal Income Tax - Subchapter 5 Corporations - Stockholders as Corporate Employees - The Deductibility of Food and Lodging - Wilhelm v. United States

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FEDERAL INCOME TAX—Subchapter S Corporations—Stockholders as Corporate Employees—The Deductibility of Food and Lodging. Wilhelm v. United States, 257 F. Supp. 16 (D. Wyo. 1966).

Prior to 1960, W. E. Dover and Ruby K. Dover owned ranch lands in Platte and Albany Counties in Wyoming. The lands in Platte County consisted of two units, the Home Place, where the Dovers lived, and the Brush Creek Ranch. Early in 1960, the Dovers gave nearly 2,000 acres of the Brush Creek Ranch to their daughter and son-in-law, the Wilhelms, who shortly thereafter moved onto the ranch and into a $27,000 house built for them by the Dovers. Later in 1960, the livestock and equipment owned by the Dovers and Wilhelms, along with the land and buildings, were transferred to a newly formed corporation, the "Thirty-One Bar Ranch Company." All common shares were owned by the Dovers and Wilhelms. Also on the day of incorporation an election was filed by the corporation electing to have its income taxed directly to its shareholders under Subchapter S.[1]

The taxpayers duly filed their 1961 Federal income tax returns, reporting cash salaries received from the corporation and deducting their respective shares of the net operating loss incurred by the corporation in 1961. The corporation's 1961 Federal income tax return was audited but the Government disallowed amounts deducted for the food and lodging (in the form of depreciation on the Home Place and Brush Creek residences) furnished by the corporation to its shareholder-employees. In the ensuing action the court, in addition to sustaining the deductibility of the food and lodging by the ranch corporation, also held that these same amounts were excludible from the gross income of the shareholder-employees under the provisions of section 119 Internal Revenue Code of 1954. The government was not authorized to appeal the case by the Solicitor General of the United States,[2] even though the significance of the holding, if allowed to stand, is patently obvious.

A contrary result could have been reached, had the court adopted any one of four arguments relied on by the Government. Therefore, an analysis of the case can best

1. INT. REV. CODE OF 1954, § 1371(a).
2. 6 P-H 1967 FED. TAX SERV. ¶ 56,344.

be accomplished by considering the court's response to the Government's main contentions.

First, the Government argued that the effect of an election under Subchapter S is to convert the corporation into a partnership, thereby making the shareholders, in effect, partners.[3] Since a partnership has no legal existence independent from the individual partners, the partners and the partnership are one and the same legal entity, hence under the taxing statute a member of a partnership cannot be an employee thereof.[4] The Government therefore contended that the provisions under section 119, which apply only to employees, should not be available to the petitioners. No authority was cited by the Government to support its original premise that an election under section 1372 converted the corporation into a partnership and the stockholders into partners. The court in *Wilhelm* was unable to agree with this contention after having reviewed the legislative history pertaining to Subchapter S under sections 1371-1377.

The Subchapter S sections became a part of the 1954 Internal Revenue Code by virtue of the Technical Amendments Act of 1958.[5] Nothing in the Act, or in the Senate Finance Committee Reports indicates an intent to treat a corporation electing under section 1372 as a partnership.[6] The express purpose of the Subchapter S section was to "eliminate the influence of the Federal income tax in the selection of the form of business organization which may be most desirable under the circumstances."[7] Also, according to the Regulations,[8] the effect of a valid election by the corporation is merely to subject the shareholders to the provisions of section 1373 (providing for the taxation of the corporation's undistributed taxable income to the shareholders). There appears to be nothing in the legislative his-

3. *See* INT. REV. CODE of 1954, § 1371 for a definition of who may elect the special tax treatment, and § 1372 as to how the election is made and its consequent effect.
4. Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956), *see also* Wilson v. United States, 19 AM. FED. TAX REP.2d 1225 (1967).
5. 72 Stat. 1606 (1958); *See* the governing principles underlying the Technical Amendments Act of 1958 as set forth in the Senate and House Reports collected in 1958 U.S. CODE CONG. & AD. NEWS 4876-78, 5005-14.
6. *Id.*
7. SENATE FINANCE COMM. REPORT TO ACCOMPANY H.R. 8300, 1954 U.S. CODE CONG. & AD. NEWS 4752.
8. Treas. Reg. § 1.1372-1(b)(2) (1959).

tory of Subchapter S, nor in the Internal Revenue Code, nor in the Treasury Regulations, which would support the Government's contention. Although the existence of the argument was recognized as early as 1960, leading writers in the field of income tax had no trouble refuting both the premises underlying the argument and therefore, the argument itself.[9] The court in *Wilhelm* was obviously correct in refusing to regard the Subchapter S election as effectively converting a corporation into a partnership.

Closely related to the Government's first contention, but yet something different is the concept of piercing the corporate tax veil. "When a sham or device is resorted to for the purpose of distorting the true situation the resulting smoke screen will be pierced to ascertain the truth."[10] The Government in the *Wilhelm* case argued that the corporate form of the Thirty-One Bar Ranch should be disregarded because the Dovers and the Wilhelms *were* the corporation and could not be its employees. A leading text in the field of income tax[11] recognizes that there have been instances where the courts have disregarded the corporate entity and have looked to the stockholders themselves as the real parties in interest. Generally this has been done when:

1) the corporation is a mere agent for the stockholder.

2) the business of the corporation is so intermingled with the stockholder as to constitute a single business enterprise.

3) in cases of tax evasion, fraud, sham and other

9. Caplin, *Subchapter S v. Partnership*, 46 VA. L. REV. 61 (1960). The author, who was later to become Commissioner of Internal Revenue, stated categorically that in his opinion Subchapter S corporations and their employee-stockholders qualify for all fringe benefits available to employees of "regular" corporations. His list included:
   Deferred compensation plans § 401-404;
   Accident and Health Plans § 105;
   Group Term Life Insurance Treas. Reg. § 1.61-2(d)(2) (1957);
   Employee Death Benefits § 101(b);
   Restricted Stock Options § 421;
   Convenience of Employer Rules § 119.
   See also Landis, *Advantages and Disadvantages of the Subchapter S Election*, 18 N.Y.U. INST. ON FED. TAXATION 723 (1960).
10. Adams Bros. v. Commissioner, 222 F.2d 501, 505 (8th Cir. 1955).
11. *See* 7 J. MERTENS, LAW OF FEDERAL INCOME TAX, § 38.04-.15 (1956) and the cases collected therein.

non-bona fide transactions involving no real business purpose.[12]

However, the discussion in the text also recognizes that a taxpayer has the right to avoid or decrease his tax liability by methods permitted by law.

Some courts have gone so far as to list up to twenty-eight factors which, if present, may give rise to the inference that the corporation is not separate and distinct from its shareholders.[13] Normally, a Subchapter S corporation is not a pseudo corporation per se; it is a real corporation, for all corporate purposes, which has simply elected to be subject to Federal income tax in a special way.[14] The Government had to admit as much in support of its first argument because only "domestic corporations" can make the Subchapter S election.[15]

No comprehensive generalizations can be made and whether the entity will be disregarded depends on the factors existing in each case.[16] The court in *Wilhelm* after an examination of both the record and the very few facts introduced by the Government concluded that "the Thirty-One Bar Ranch Co. was incorporated according to the law and in good faith. The corporation alone conducted the taxpayer's ranching operations. It was a separate and distinct corporate *and taxable entity.*"[17] The court recognized that the inference that the taxpayers might have been motivated by tax considerations is unimportant, so long as they did what the law permits,[18] and that the determination of tax liability is not necessarily influenced by the taxpayers complete stock ownership and control.[19] Since the Government failed to introduce evidence to support its argument that the cor-

12. *Id.* at 38.08, 38.12.
13. Haberman Farms, Inc. v. United States, 305 F.2d 787 (8th Cir. 1962). The test used by this court was that the corporate entity should be disregarded if the corporate form is no more than the alter ego of the taxpayer, a form which may have a distinct tax purpose, *but with no reality beyond lessening the tax burden.*
14. Patty, *Qualification and Disqualification Under Subchapter S*, 18 N.Y.U. INST. ON FED. TAXATION 661 (1960).
15. INT. REV. CODE OF 1954, § 1371(a).
16. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).
17. Wilhelm v. United States, 257 F.Supp. 16 (D. Wyo. 1966).
18. Here the court cited Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959) in support of its statement.
19. *Cf.* Skarda v. Commissioner, 250 F.2d 429 (10th Cir. 1957); Noland v. Commissioner, 269 F.2d 108 (4th Cir. 1959).

porate entity should be disregarded, the court saw no reason to treat the Thirty-One Bar Ranch as a partnership or the Dovers and Wilhelms as partners.

The Government's third principal argument was based on section 316 of the Internal Revenue Code of 1954. The taxpayer's living expenses paid by the corporation were contended to be nothing more than a constructive dividend.[20] However, unless a distribution is made to the taxpayer, or for his *benefit,* it may not be regarded as either a dividend or the legal equivalent of a dividend.[21] The use of corporate property for personal pleasure,[22] or payments made merely because the recipients were the owners of the corporation[23] have been treated as dividend distributions. The court in *Wilhelm,* however, held that the food and lodging were provided for the *benefit* of the corporation, not the taxpayer. The court also held that the taxpayers derived no personal pleasure from the use of corporate property, and that food and lodging were supplied to all corporate employees regardless of stock ownership. Even more detrimental, conceptually, to the Government's constructive dividend argument was its willingness to concede that the food and lodging were properly deductible by the ranch corporation as business expenses under section 162(a) and section 167(a). It is difficult to grasp how the amounts involved are transmuted from an ordinary and necessary expense[24] of carrying on the business of the ranch corporation into constructive dividends in the hands of the taxpayer-employees. Never have dividends paid by a corporation to its stockholders been considered an ordinary and necessary business expense.[25]

The Government's fourth principal contention was predicated on the most basic definition in income tax law: *Income means all income from whatever source derived.*[26] Income may be realized therefore in the form of services, *meals, accommodations* . . . as well as in cash,[27] hence there can be no

20. INT. REV. CODE OF 1954, § 316(a).
21. Holsey v. Commissioner, 258 F.2d 865 (3rd Cir. 1958).
22. W. D. Gale, Inc. v. Commissioner, 297 F.2d 270 (6th Cir. 1961).
23. Louisville Chair Co. v. United States, 296 F.2d 621 (6th Cir. 1961).
24. INT. REV. CODE OF 1954, § 162(a) reads in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."
25. *See* INT. REV. CODE OF 1954, §§ 161-62.
26. INT. REV. CODE OF 1954, § 61.
27. Treas. Regs. § 1.161-1(a) (1958) (Emphasis supplied).

question but that the value of food and lodging furnished to the taxpayers would fall within this statutory definition of gross income,[28] absent any exclusion to the contrary. But section 119 of the Internal Revenue Code introduced and relied on by the taxpayer does exclude such income, at least in specific instances:

> There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—
>
> (1) in the case of meals, the meals are furnished on the business premises of the employer or,
>
> (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of employment.[29]

This provision was designed to end the confusion as to the tax status of meals and lodging furnished to an employee by his employer.[30] The application of the three basic tests embodied in this section to the facts of a specific case has caused considerable difficulty. The Government in the *Wilhelm* case made a blanket allegation that the taxpayers were not within the provisions of section 119, but it failed to show which of the tests, if any, were not met. The court in *Wilhelm*, anticipating questions that could have been raised more specifically by the Government discussed each of the three tests in turn.

Whether the meals and lodging were furnished on the business premises is the first test that has to be met in applying the exclusionary section, section 119. Meals furnished to a cowhand while herding his employer's cattle on leased lands or on national forest lands used under a permit would be regarded as having been furnished on the business premises for purposes of section 119.[31] In a recent case involving highway patrolmen, the business premises for purposes of section 119 were held to include all highways within the state.[32] These sources illustrate the broad scope of the busi-

28. Note 26 *supra*.
29. INT. REV. CODE OF 1954, § 119.
30. SENATE FINANCE COMM. REPORT, *supra* note 7 at 4042.
31. H. CONF. REP. No. 2543, 83d Cong., 2d Sess. (1954).
32. United States v. Morelan, 356 F.2d 199 (8th Cir. 1966).

ness premises rule. In *Wilhelm* the court correctly concluded that no reasonable dispute could arise as to whether the meals and lodging were furnished on the ranch-employer's business premises.

The second test embodied in the phrase, "required as a condition of employment," means required in order for the employee to perform properly the duties of his employment.[33] There is no requirement that the employee be deprived of his free choice in lodging or boarding, nor is it essential that the employee be under an express requirement by the employer to accept the lodging furnished. It is enough to satisfy the requirements of section 119(2) that the exigencies of the situation, as a practical matter, require the employee to accept the lodging furnished.[34] The intention of the employer (with respect to food and lodging being furnished as a compensation) is not particularly important and an objective test is to be applied in determining whether the employee is required to accept lodging on the business premises as a condition of employment.[35] The burden of proof is on the taxpayer, and for instance, even though the minutes of a directors meeting expressly provide that the employee of the corporation must accept lodging furnished to him as a condition of his employment, such an agreement is not conclusive.[36] In another recent case, the principal stockholder and his sister (also a stockholder) were not allowed to exclude the value of lodging furnished to them by the controlled corporation.[37] The court indicated that since the taxpayer's job did not require his full time presence at the business site and that since he could have lived in one of two towns, each ten miles away, the lodging was not accepted as a condition of employment. In *Wilhelm* the court apparently felt the objective test and the burden of proof had been successfully met by the taxpayers. Because no other housing and boarding facilities were available to the ranch employees and because they had no other choice but to accept the

33. Treas. Reg. § 1.119-1(b) (1964).
34. Manuel G. Setal, 30 P-H TAX CT. MEM. ¶ 61,156, at 61,853 (1961).
35. United States Junior Chamber of Commerce v. United States, 334 F.2d 660 (Ct. Cl. 1964).
36. Lloyd E. Peterson, 35 P-H TAX CT. MEM. ¶ 66,196, at 66,1127 (1966), wherein it was said, "It seems quite unlikely that the president of this company, particularly since he had voting control, would be required to live on the company property had he desired to live elsewhere."
37. Mary B. Heyward, 36 T.C. 739 (1961), *aff'd.* 301 F.2d 307 (4th Cir. 1962).

facilities furnished by the corporate employer, the taxpayers had according to the court, "made it abundantly clear that the food and lodging were accepted as a condition of employment."[38]

The third test as to whether meals are furnished for the convenience of the employer is one of fact to be determined by an analysis of all the facts and circumstances in each case.[39] The Wilhelms managed a grass ranch which, as their evidence showed, required constant attention by experienced personnel. The cattle on a grass ranch must constantly be protected from the natural elements, weather, straying, and thievery. The nearest town, Wheatland, is 24 miles away by a road which is exceedingly difficult to travel during foul weather. The presence of the taxpayer-employees was held to be indispensible by the court and therefore, for the convenience of the employer. Two very recent cases lend support to the *Wilhelm* court's conclusion regarding the convenience of the employer test. The rental value of a bunkhouse and amounts spent for food were claimed to be excludible by an Oklahoma rancher. The amounts were disallowed by the Internal Revenue Service because the taxpayer was a partner in the ranch operation; but the implication remained that had the ranch been incorporated, the deductions would have been allowed.[40] The other case involved an incorporated poultry farm and the facts were similar to those in *Wilhelm*. It was held that food and lodging furnished by the corporation were includible in the taxpayer-shareholder's income because the taxpayer could have lived in town a short distance away.[41] The remaining implication here was that had the ranch been located a substantial distance from town (as in *Wilhelm*) the amounts could have been excluded under section 119.

CONCLUSION

Generally income tax deductions for personal, family or living expenses are not allowed.[42] The taxpayers in *Wil-*

38. Wilhelm v. United States, *supra* note 17.
39. Treas. Reg. § 1.119-1(a)(1) (1964).
40. Wilson v. United States, 19 AM. FED. TAX REP. 2d 1225 (1967). *Accord*, Commissioner v. Doak, 234 F.2d 704 (1956).
41. Lloyd E. Peterson, *supra* note 36.
42. INT. REV. CODE OF 1954, § 262. *See also* Treas. Reg. § 1.262-1(b)(3) (1958) for a specific enumeration.

helm have managed to circumvent this general principle by availing themselves of several other Code provisions. In essence, they have deducted personal, family, and living expenses, because such a deduction from the Subchapter S corporation's income is, effectively, a deduction from the shareholder-employee's income. Although, on first impression, it might appear that *Wilhelm* is contrary to the spirit of our taxing laws, the validity of the underlying principle has been indirectly recognized by the Internal Revenue Service. Revenue Ruling 63-32[43] provides that a partnership which had elected to be taxed as a corporation, under section 1361 of the Code, might deduct the cost of meals and lodging furnished to a partner-employee on its business premises, and the partner-employee might exclude the value of such meals and lodging from his gross income, providing that the partnership and the partner-employee have met all the tests set forth in section 162 (Business Deductions) and section 119 of the 1954 Code. Extending this ruling to include corporations electing to be taxed as a partnership under section 1371 in addition to partnerships electing to be taxed as corporations under section 1361, would be a short step indeed. The fact that the Government failed to appeal in *Wilhelm*[44] does not necessarily mean that the decision will be followed. The Commissioner may be awaiting a slightly more favorable set of facts, the state of the record after trial may not have been entirely advantageous or, perhaps other reasons not involving the merits of the case have influenced the decision. A taxpayer with a case similar to *Wilhelm* must be prepared for possible litigation with the Internal Revenue Service.

In 1959, shortly after it became apparent that extensive fringe benefits would be available to the shareholder-employees of a Subchapter S corporation, Chairman Wilbur Mills introduced a bill in his House Ways and Means Committee which provided that those owning more than 5% of a section 1371 corporation's outstanding stock, quote, "would not be considered employees for purpose of the fringe benefit provisions."[45] The bill however, was never reported out

43. 1963-1 CUM. BULL. 146.
44. Note 2 *supra.*
45. H. R. 9003, 86th Cong., 1st Sess. (1959). *See* Cohen, *Subchapter S in 1967*, 53 VA. L. REV. 1161 (1967).

of committee and during the succeeding years fringe benefits have continued to be available to shareholder-employees. Dicta in other cases,[46] Revenue Ruling 63-32, and legislative inaction since the Mills bill add considerable weight to the decision in *Wilhelm*. If, in the future, a similar case arises, the principles developed in *Wilhelm* signal a like result—absent a future Revenue Ruling or Congressional Act to the contrary.

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46. Particularly Commissioner v. Doak, note 4 *supra;* Lloyd E. Peterson, note 36 *supra;* Mary B. Heyward, note 37 *supra.*