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## MEALS AND LODGING IN S CORPORATIONS

— by Neil E. Harl\*

For many years, meals and lodging provided to employees have been subject to special tax treatment.<sup>1</sup> Employees of C corporations have always been eligible for tax-privileged treatment of meals and lodging;<sup>2</sup> employees of S corporations have been limited in eligibility by the rules in force since 1982.<sup>3</sup> A recent Wyoming District Court decision has focused attention on the differences in treatment for employees between C and S corporations.<sup>4</sup>

### General rule on meals and lodging

As a general rule, meals and lodging furnished to an employee for the convenience of the employer do not constitute taxable income for the recipient.<sup>5</sup> To be excluded from income, the meals must be furnished on the business premises of the employer;<sup>6</sup> for the lodging to be excluded, the employee must be required to accept the lodging on the premises as a *condition* of employment.<sup>7</sup> The term "lodging" includes such items as heat, electricity, gas, water and sewer service unless the employee contracts for the utilities directly from the supplier.<sup>8</sup>

Farm employees have been successful in excluding the value of meals and lodging from income in several cases since the late 1930s.<sup>9</sup> A few cases have been unsuccessful for the taxpayer<sup>10</sup> including one where the employee's duties were supervisory and could have been performed adequately while living in a nearby town.<sup>11</sup>

### Limits for S corporations

Employees of S corporations face two sets of limitations in applying the general rule on treatment of meals and lodging.

- For residences owned by S corporations and occupied by a shareholder, deductions are allowed to the corporation only to the extent the residence is used regularly and on an exclusive basis for business purposes.<sup>12</sup> Thus, most of the residential costs (other than for an office in the home or other business use) are not deductible by the corporation<sup>13</sup> and the value of the lodging will not be included in the employees' gross income.<sup>14</sup>

- As for meals, any shareholder in an S corporation owning more than two percent of the corporation's stock is treated as a partner in a partnership.<sup>15</sup> As a result, the value

of any meals provided by the corporation is not eligible for preferential treatment.

### *Dilts v. United States*

The recent case of *Dilts v. United States*<sup>16</sup> involved an S corporation engaged in ranching. The husband and wife, the sole corporate officers, lived in a home owned by the corporation and excluded the value of the residence and groceries from their income. Corporate deductions for heat, telephone, electricity, depreciation, insurance, repairs and groceries were disallowed by IRS.

The taxpayers' argument that the expenses should be deductible as ordinary and necessary business expenses failed.<sup>17</sup> The taxpayers then argued that, since they were treated as partners in a partnership, the costs should be deductible under the authority of *Armstrong v. Phinney*.<sup>18</sup> That case involved a partner in a large farm partnership who argued, successfully, that a partner could be an employee of the partnership for purposes of meals and lodging expense. The court in *Dilts v. United States*<sup>19</sup> distinguished *Dilts* from *Armstrong v. Phinney*<sup>20</sup> on the grounds the taxpayers in *Dilts* were not employees.

The court in *Dilts* made no mention of the statutory provision on disallowing deductions for lodging expense.<sup>21</sup>

The court in *Dilts* then proceeded to undercut the 1966 case of *Wilhelm v. United States*,<sup>22</sup> which was decided by the same court. The *Dilts* court stated that "This Court now holds that the reasoning in that case is no longer persuasive, especially given the public policy considerations..."<sup>23</sup>

The *Dilts* court explained its "public policy" reasoning as follows:

"...the result which the plaintiffs see would lead to inequitable results which are contrary to public policy and congressional intent. One fundamental purpose of the tax code is to achieve "horizontal equity" — that is, to treat similarly situated people in the same manner. The plaintiff's interpretation of the code violates this principle. Taxpayers like the plaintiffs would get the benefits of exclusions which sole proprietors would not be able to take. This Court cannot fathom any substantive reason why the owners of a subchapter S corporation should be entitled to such exclusions while their neighbors, sole proprietors, would not be entitled to the same exclusion. In addition, it is hard to believe that Congress intended, via the §§1372, 707, 119

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scheme, to create a widespread exclusion for the food and housing expenses of agricultural and ranch owners who happen to organize their business under Subchapter S. Indeed if this were true, then one would expect all ranchers and farmers to organize under Subchapter S and exclude all their housing and lodging expenses from their income. This would hardly be a fair result unless all business owners who must live in the city to be near their business for a variety of reasons were allowed to deduct their food and lodging expenses as well. Such a result is unthinkable and this Court will not construe the IRC to reach this outcome."

Although only dictum, this passage demonstrates that the *Dilts* court fundamentally misunderstands both the corporate structure and the statutory provisions under I.R.C. § 119. Certainly, a farm corporation can and does have employees and, if it is a C corporation, the employees have long been entitled to exclude the value of meals and lodging from income. The court in *Dilts* reached the correct conclusion but, unfortunately, in careless dictum has improperly cast doubt on the handling of meals and lodging by farm and ranch corporations. The slap at *Wilhelm v. United States*<sup>24</sup> was gratuitous and unnecessary. That case was decided long before either of the limitations was enacted for S corporations on the handling of meals and lodging.

#### FOOTNOTES

- <sup>1</sup> See I.R.C. § 119. See generally 7 Harl, *Agricultural Law* § 57.03[2] (1994).
- <sup>2</sup> *Id.*
- <sup>3</sup> See I.R.C. §§ 280A(a), (c), 1372.
- <sup>4</sup> *Dilts v. U.S.*, 94-1 U.S.T.C. ¶ 50,162 (D. Wyo. 1994).
- <sup>5</sup> I.R.C. § 119.
- <sup>6</sup> I.R.C. § 119 (a)(1).
- <sup>7</sup> I.R.C. § 119(a)(2). See *Crowe v. U.S.*, 4 Cls. Ct. 734 (1984); Ltr. Rul. 8826001, Oct. 14, 1987 (value of housing provided by employer included in employees' income when housing not provided at work site and not provided in one "camp" but scattered within housing generally available to public); Ltr. Rul. 9126063, March 29, 1991 (value of off-premises lodging and utilities included in gross income).
- <sup>8</sup> Rev. Rul. 68-579, 1968-2 C.B. 61. See *Harrison v. Comm'r*, T.C. Memo. 1981-221 (amounts for gas and electricity paid by corporation in grain and dairy operation were necessary for residences to be habitable and so excludable from income of employees). See also *Vanicek v. Comm'r*, 85 T.C. 731 (1985), *acq.*, 1986-1 C.B. 1 (portion of cost of utilities for residence provided by employer not deductible because of lack of evidence by which utility costs could be apportioned between business and personal use).
- <sup>9</sup> *Greene v. Kanne*, 38-1 U.S.T.C. ¶ 9206 (D. Hawaii 1938) (value of quarters provided to plantation manager not taxable); *Renton v. Kanne*, 38-1 U.S.T.C. ¶ 9207 (D. Hawaii 1938)(same); *Wilhelm v. U.S.*, 257 F. Supp. 16 (D. Wyo. 1966) (value of food and lodging provided by ranching corporation not taxed to shareholder-employees); *Caratan v. Comm'r*, 442 F. 2d 606 (9th Cir. 1971) (Commissioner not sustained in adding \$1200 to gross income of each stockholder-employee of closely-held corporation who lived in corporation-owned house on business premises); *J. Grant Farms, Inc. v. Comm'r*, T.C. Memo. 1985-174 (swine raising and grain drying operation; value of lodging and utilities excluded from income); *Johnson v. Comm'r*, T.C. Memo. 1985-175 (husband-wife, sole shareholders, allowed exclusion from income of fair rental value of corporation-owned residence on premises when husband was manager of corporation's grain drying and storing operation).
- <sup>10</sup> *Roberts v. Comm'r*, 17 P-H Tax Ct. Mem. 516 (1948) (rental value of corporate-owned farm house occupied by sole shareholder of farm corporation was taxable income).
- <sup>11</sup> *Peterson v. Comm'r*, T.C. Memo. 1966-196 (poultry breeding operation).
- <sup>12</sup> I.R.C. § 280A(a), (c). See *Proskauer v. Comm'r*, T.C. Memo. 1983-395.
- <sup>13</sup> *Id.*
- <sup>14</sup> I.R.C. § 119.
- <sup>15</sup> I.R.C. § 1372.
- <sup>16</sup> 94-1 U.S.T.C. ¶ 50,162 (D. Wyo. 1994).
- <sup>17</sup> *Id.*
- <sup>18</sup> 394 F.2d 661 (5th Cir. 1968).
- <sup>19</sup> See n. 15 *supra*.
- <sup>20</sup> See n. 17 *supra*.
- <sup>21</sup> I.R.C. § 280A(a), (c).
- <sup>22</sup> 257 F. Supp. 16 (D. Wyo. 1966).
- <sup>23</sup> 94-1 U.S.T.C. ¶ 50,162, n. 7 (D. Wyo. 1994).
- <sup>24</sup> 257 F. Supp. 16 (D. Wyo. 1966).

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## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

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### ANIMALS

**HORSES-ALM § 1.01[2].\*** The plaintiff was injured when the plaintiff's automobile struck a mare owned by the defendant. The defendant lived on the farm but worked in a nearby city and often spent several days away from the farm. The defendant hired a worker to feed the horses but the worker quit without notice several days before the accident. Although the horses were kept in a fenced corral and barn, the horses escaped and one wandered onto the

highway and was struck by the plaintiff's car. The plaintiff claimed that the defendant was negligent in failing to properly confine the horse and in failing to hire a responsible and careful worker. The plaintiff also claimed that the defendant was negligent because the defendant, through the worker, had constructive knowledge of the escape of the horses. The court held that the evidence showed that the defendant had no knowledge of the escape until after the accident and that the worker quit before the escape; therefore, the defendant had no prior actual or