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Unified Business Enterprise Theory Flies First Class

By Christopher Karachale • Wood & Porter • San Francisco

In the *Metaphysics*, Aristotle states, "The whole is greater than the sum of the parts." He makes this observation in the context of the various forms something can take, a type of transmutation. A bottle of wine may turn to vinegar if it is not imbibed at the right time. In other words, the same liquid that is wine may become vinegar so it possesses the ability to have both forms.

Like a good bottle of wine, business expense deductions must be taken at the right time and in the right form. Wait too long and your deduction may turn to vinegar. Aristotle's observation also rings true for taxpayers looking to maximize their business deductions when they possess a variety of interrelated entities engaged in similar business endeavors.

In the appropriate circumstances, the unified business enterprise theory may allow various distinct business entities to share their profit motives. Of course, by sharing motives, they may share tax benefits and burdens too. In effect, for purposes of Internal Revenue Code Section ("Code Sec.") 162, their sum is greater than their parts.

Deduction Basics

In general, Code Sec. 162 allows a taxpayer to deduct all ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. For all their vast breadth, there are a variety of limitations on such ordinary and necessary deductions. For example, in the cases of individuals and S corporations, Code Sec. 183 may limit deductions if the activity is not engaged in for profit.

Code Sec. 183 is better known as the "hobby loss rule." In some ways, it is an unfortunate moniker. The Code section was actually enacted to prevent wealthy individuals from generating paper losses for the purpose of sheltering unrelated income. [*See* S. REP. NO. 552, 91st Cong., 1st Sess., reprinted in 1969 U.S.C.C.A.N. 2027, 2376–77.] However, if you

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are fighting a "hobby loss" tax case, it sounds vaguely seedy, or at least gives the appearance that you really shouldn't be offsetting "real" income with a pleasurable pursuit.

In determining whether a taxpayer has the necessary profit objective in order to clear the Code Sec. 183 hurdle, courts consider various facts and circumstances:

1. The manner in which the taxpayer carried on the activity
2. The expertise of the taxpayer or his advisors
3. The time and effort expended by the taxpayer in carrying on the activity
4. The expectation that assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on other similar or dissimilar activities
6. The taxpayer's history of income or losses with respect to the activity
7. The amount of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. The presence of personal pleasure or recreation [*See* Reg. §1.183-2(b).]

The Unified Business Enterprise Theory

Reg. §1.183-1(d) provides that if a taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated in determining whether a particular activity is engaged in for profit. However, multiple undertakings *may* be treated as one activity if the undertakings are sufficiently interconnected. Such interconnectedness is determined in part based on the degree of organizational and economic interrelationship of the various undertakings. Also relevant are the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting and the similarity of various undertakings. [*See id.*]

This interconnectedness of entities is an important factor in determining whether Code Sec. 183 will serve as a bar to ordinary and necessary business deductions. Known as the "unified business enterprise theory," such interconnected entities can provide deductions for costs that do not appear to have a profit motive as long as such costs are incurred in the *overall* trade or business. In that way, even if a unique cost does not have a profit motive, it may still be deductible when viewed as a sum of all the parts of a particular business endeavor that has an overarching profit motive.

High-Flying Profits

Nowhere is the question of a profit motive more closely scrutinized than in the context of airplane ownership. Private and corporate aviation interests often tout the efficiency and cost savings of this increasingly ubiquitous "necessity." Still, often the maintenance, operation and care of airplanes owned by wealthy individuals and their corporate entities create extensive losses.

In numerous instances, the IRS has argued that the losses tended to show a lack of sufficient profit motive. Therefore, the IRS asserted, the expenses were nondeductible. So much, it would seem, for all the aircraft

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marketing hype about cost savings.

Interestingly, though, taxpayers have sometimes been able to rebut the IRS's arguments with the unified business enterprise theory. For example, in *D.R. Campbell*, CA-6, 89-1 USTC ¶9186, 868 F2d 833 (1989), the Sixth Circuit addressed whether a member of a partnership, which purchased an airplane and leased it to a corporation controlled by the partners, was engaged in an activity undertaken for profit under Code Sec. 183. The shareholders of the corporation were substantially the same as the partners (creating an interconnectedness of entities).

The airplane was the partnership's only asset. Despite the fact that the partnership generated substantial losses, the court found that the relationship between the partnership and the corporation established the requisite profit motive for purposes of Code Sec. 183. According to the Sixth Circuit: "The entire economic relationship and its consequences are what determine profit motive" under the Code Sec. 183 test. [*Campbell*, 868 F2d at 836–37.]

In *E.C. Lee,* 51 TCM 1438, Dec. 43,180(M), TC Memo. 1986-294 (1986), a taxpayer purchased an airplane with personal funds with the intent of allowing a corporation he owned to use it (and in anticipation that the corporation would realize a profit from its use). He was found to have a *bona fide* profit motive in operating the plane. Similarly, in *G.E. Louismet*, 43 TCM 1496, Dec. 39,054(M), TC Memo. 1982-294 (1982), the principal user of the taxpayer's charter aircraft service was a commodities business in which the taxpayer held a substantial ownership interest. Here too, the court found the taxpayer's intention to profit from the commodities business established his profit motive in the air charter business. They were integrated. Finally, in *B. Cornfeld*, CA-DC, 86-2 USTC ¶9613, 797 F2d 1049 (1986), the court found that a taxpayer who leased his airplane to an aircraft charter service of which he was a stockholder had an honest profit objective in so doing.

Profits Keep on Rocking

A recent case demonstrates the continuing benefits of the unified business enterprise theory in the context of the Code Sec. 183 profit motive determination. In *Morton*, 2011 U.S. Claims LEXIS 661 (Ct. Cl. 2011), the U.S. Court of Federal Claims examined whether expenses incurred in the operation of an airplane owned and operated by entities under the control of Peter Morton, the founder of the Hard Rock Café, were deductible under Code Sec. 162. The Hard Rock Café, for those who may have missed the hair metal days of the late 1980s, serves as the "world's leading collector and exhibitors of rock 'n' roll memorabilia."

Morton owned (directly or indirectly) a variety of entities which controlled his interest in the Hard Rock brand. He was the sole or majority shareholder of several S corporations, including Red, White and Blue Pictures, Inc. ("RWB"), Lily Pond Investments ("Lily Pond"), and 510 Development Corporation ("510 Development"). RWB owned the real estate underlying some of the Hard Rock Cafés and acted as landlord.

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Lily Pond was a holding company that owned all the voting shares and 94 percent of the total shares of the Hard Rock Hotel, Inc. ("HRH"), a C corporation. That C corporation, in turn, owned and operated the Hard Rock Hotel and Casino in Las Vegas. 510 Development performed marketing, design, public relations, management services and accounting services for HRH and served as the employment vehicle for Mr. Morton's staff.

As any aging rocker should, Morton also owned a Gulfstream jet through the S corporation RWB. Morton used the jet for both personal and business purposes including the promotion of the Hard Rock brand and conducting business related to the Hard Rock Hotel and Casino in Las Vegas. Morton's pilot kept flight logs detailing the use of the plane (very good!). His CFO maintained a spreadsheet showing which uses were personal and which were business related (also very good).

The Golden Mean

The IRS audited and, among other issues, disallowed the business expenses deducted under Code Sec. 162 for the operation of Morton's plane. The IRS asserted the lack of profit motive under Code Sec. 183. The Court of Federal Claims disagreed, finding that the various interrelated S corporations represented a unified business enterprise that could be aggregated in determining the existence of a profit motive.

In the court's view, Morton had an interest in promoting the overall Hard Rock brand and his interconnected S corporations worked towards furthering the promotion of the brand for Morton's business benefit. Morton worked for the Hard Rock Hotel and Casino in Las Vegas (through HRH and Lily Pond) and the Hard Rock Cafés' real estate interests (through RWB). This work, in turn, benefited all the entities by promoting the overall brand.

In addition, this work (facilitated by the use of the airplane) created revenue for the entities and for Morton himself. Therefore, the court found Morton's entities were intertwined and formed a unified business enterprise that operated for profit-making purposes.

For purposes of the actual costs incurred in the operation of the airplane, the court pointed out the activities of the various S corporations were clearly in furtherance of other entities of similar ownership. Morton and RWB purchased the aircraft with the intention of furthering HRH's business purpose. The dispositive issue, it appears, was that the business activity undertaken by RWB and Morton benefited all of Morton's other S corporations including Lily Pond (through which Morton owned the Hard Rock Hotel and Casino in Las Vegas) and 510 Development.

Conclusion

These days, more and more audits and tax disputes involve airplanes. Indeed, this is true even in businesses of relatively modest size and scope. While we may not each have our own Gulfstream jet (like Peter Morton), increasingly these privately operated aircraft are an important part of many corporate businesses.

In this respect, *Morton* serves as a helpful reminder that unified business enterprise theory is a valuable tool in the Code Secs. 162 and 183 analyses. Especially in the treacherous area of airplane ownership and its related costs, multiple S corporations can be aggregated to demonstrate the requisite profit motive for purposes of ordinary and necessary business deductions.

In this area of the law, Aristotle's admonition remains particularly apt. The whole is surely greater than the sum of its parts. Taxpayers who organize their business activities through related S corporations may find that the whole entity is greater that its constituent parts when seeking to deduct costs.