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Morton Case Limits IRS Application of Hobby Loss Rules

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By Phil Crowther

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The recent court case of *Morton v. United States*[1] held that the aircraft operations of Peter Morton, a co-founder of Hard Rock Café, were conducted as part of a "unified business enterprise" with his other business activities and therefore were not subject to the hobby loss limitations. In this taxpayer-friendly case, the court included Morton's aircraft operations in the "unified business enterprise" for hobby loss purposes arguably without applying the list of aggregation factors in the Income Tax Regulations. This case may also be helpful to taxpayers because the other businesses in the "unified business enterprise" included a C corporation.

BACKGROUND

Many business owners conduct business using several different legal entities, including C corporations, S corporations, partnerships, and limited liability companies (LLCs). For liability and other business reasons, they will often put their aircraft in one of their business entities or in a separate leasing company that leases the aircraft to one or more business entities. Although these arrangements generally do not create any income tax benefits for the owner, the depreciation rules often cause the entity owning the aircraft to have a tax loss. In recent years, IRS auditors have tried to disallow deduction of these losses, relying on the "hobby loss" rules.

Under the hobby loss rules, an individual or an S-corporation ("S-corp") cannot deduct net losses from an activity that is not engaged in for profit.[2] In addition, the IRS has held that the rules also apply to a partnership – which would include an LLC taxed as a partnership.[3]

The court in *Morton* explained that to be engaged in an activity for profit, the taxpayer's primary purpose for engaging in the activity must be for income or profit.[4] In another case, the Tax Court explained the appropriate

National Business Aviation Association 1200 18th Street NW, Suite 400 Washington, DC 20036 (202) 783-9000 www.nbaa.org

standard as follows:

> The basic standard for determining whether an expense is deductible under sections 162 and 212 (and thus not subject to the limitations of section 183) is that the taxpayer must show that the taxpayer engaged in or carried on the activity with an actual and honest objective of making a profit.[5]

To determine whether a taxpayer has the requisite profit objective, the Regulations provide a nonexclusive list of nine factors to be considered.[6]

Particularly where an individual conducts an activity using several different legal entities, the issue arises of whether the profit objective must be found for the separate portions of the activity conducted in each entity or whether the profit objective should be determined for the activity as a whole. The Treasury Regulations provide that the aggregation of undertakings into a single activity for hobby loss purposes is based on all of the relevant facts and circumstances including the degree of organizational and economic interrelationship of the undertakings, the business purpose of the undertakings, and the similarity of the undertakings.[7] In determining whether it is appropriate to aggregate undertakings into a single activity for purposes of evaluating a taxpayer's profit objective, the courts have expanded this list of factors to include the following:

- Whether the undertakings share a close organizational and economic relationship,
- Whether the undertakings are conducted at the same place,
- Whether the undertakings were part of a taxpayer's efforts to find sources of revenue from his or her land,
- Whether the undertakings were formed as separate businesses,
- Whether one undertaking benefited from the other,
- Whether the taxpayer used one undertaking to advertise the other,
- The degree to which the undertakings shared management,
- The degree to which one caretaker oversaw the assets of both undertakings,
- Whether the taxpayers used the same accountant for the undertakings, and
- The degree to which the undertakings shared books and records.[8]

In *Rabinowitz v. Commissioner,*[9] the court applied these aggregation factors to hold that a separate company operating an aircraft charter business should be evaluated separately from the owner's clothing business to determine whether the aircraft operation was engaged in for profit.

In contrast, the court in *Campbell v. Commissioner*[10] held that a partnership's activity of leasing an aircraft to a commonly-owned C corporation was undertaken with a profit objective based on the benefits provided to the business conducted by the C corporation. In rejecting the IRS' argument that the profit objective behind the leasing activity must be evaluated separately, the court attributed the profit objective of the C corporation's business to the partnership, stating that "[t]he entire economic relationship and its consequences are what determine profit motive." However, the IRS did not acquiesce to this holding in *Campbell,* and, as illustrated in *Rabinowitz,* it is not clear whether the same result would follow if the court had applied the aggregation factors.

In another case, the Tax Court has held that the hobby loss rules do not permit the *aggregation* of undertakings conducted in C corporations with other undertakings.[11] However, the court in this case declined to rule on whether this limitation prevents a court from *attributing* the profit objective of a business activity in a C corporation to the taxpayer's other related activities.[12]

MORTON APPLIES 'UNIFIED BUSINESS ENTERPRISE' STANDARD

In *Morton*, the Court of Claims relied primarily on the *Campbell* case, in holding that to determine whether the hobby loss rules apply, the IRS must consider whether the taxpayer is using the aircraft as part of a "unified business enterprise." Under the facts in the case, the court considered the aircraft operations to be part of an overall business involving multiple corporations including a C corporation.

Peter Morton was a co-founder of the Hard Rock Café chain, and the creator and developer of the Hard Rock brand. He has worked in the restaurant, hotel, and gaming businesses from 1971 to the present. He conducted this business through several corporations, including a C corporation. For liability purposes, he arranged for one of these corporations, Red, White and Blue Pictures, Inc. (RWB), to purchase a Gulfstream III aircraft, which the corporation later exchanged for a Gulfstream IV aircraft. Morton used both aircraft in connection with the business of his various corporations.

Morton argued that he was entitled to deduct all of the aircraft expenses attributable to the use of the aircraft in his "unified business enterprise." In contrast, the IRS argued that the hobby loss rules prevented RWB or Morton from deducting losses attributable to the use of the aircraft for Morton's travel in connection with the business of his other corporations.

Although the court held that Morton still needed to substantiate the business use of the aircraft, the court held in favor of Morton on the hobby loss issue. The court held that the "unified business enterprise" theory applied to Morton's situation and that "[a]s long as [Morton] used [the aircraft] to further a profit motive in his overall trade or business, the deduction is allowed."

IMPLICATIONS OF *MORTON*

In general, the court's favorable holding in *Morton* suggests that a taxpayer is more likely to have his or her aircraft operations treated as part of an overall trade or business for purposes of the hobby loss rules, when that overall trade or business constitutes a single interrelated business activity.

It is difficult to predict whether a court will apply the aggregation factors under *Rabinowitz* or the attribution within a unified business enterprise analysis under *Morton*. One possible distinction is that the jet charter business in *Rabinowitz* appeared to be operating as a separate charter business, whereas in *Morton* the aircraft was simply used by Morton for his travel on the business of his companies.

In the recent case of *Stangeland v. Commissioner*,[13] the court applied the aggregation factors to hold that an individual's use of his aircraft to travel for the business of his various different corporations could not be treated as part of a single overall business activity.[14] The holding in *Stangeland* may indicate that an aircraft used for business travel for one business is more likely to be treated as part of an overall business enterprise than an aircraft that is used in multiple businesses.[15]

Morton is also helpful in demonstrating that aircraft operations conducted in passthrough entities can be viewed as part of an overall business enterprise with a business conducted in a C corporation, at least under the attribution analysis of *Morton and Campbell*.

CONCLUSION

While the *Morton* case provides a taxpayer-friendly precedent, the aggregation of undertakings into activities and the attribution of a profit objective within a unified business enterprise under the hobby loss rules remain subjective. To minimize the hobby loss risks individuals should consider placing their aircraft in the same legal entity as their operating business or using aircraft held in a separate entity in only a single operating business. If the aircraft must be used in multiple businesses, taxpayers may want to consider placing the aircraft in the entity with the primary business or charging a reasonable management fee for their services so that the aircraft is treated as used in a management services business. In view of the uncertainty about whether it is permissible to consider business activities conducted in a C corporation, individuals should be cautious about relying on the profit objective of a business conducted inside a C corporation to attribute a profit objective to aircraft operations in a pass-through entity.

ABOUT THE AUTHOR

Phil Crowther, a member of the NBAA Tax Committee, is counsel at the law firm of Jackson & Wade, LLC. He can be reached at [redacted] or pcrowher@jetlaw.com. John Hoover assisted with this article.

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END NOTES

1. 107 A.F.T.R.2d ¶2011-762, 2011-1 U.S.T.C. ¶50,346 (Ct. Cl. Apr. 27, 2011).
2. I.R.C. § 183.
3. Rev. Rul. 77-320, 1977-2 C.B. 78. Although the rules do not apply to a C-corporation ("C-corp"), all entities including C corporations are subject to the rule that an expense can only be deducted as an ordinary and necessary business expense under I.R.C. § 162, if it is incurred in an activity engaged in for profit. *Portland Golf Club v. Comm'r,* 497 U.S. 154 (1990).
4. Other courts have suggested that a primary or predominant purpose of earning a profit is not required and that the taxpayer only needs to have "a profit" objective. *Faulconer v. Comm'r,* 748 F.2d 890 n.10 (4th Cir. 1984).
5. *Schwartz v. Comm'r,* T.C. Memo 2003-86.
6. Treas. Reg. § 1.183-2(b). These nine factors were applied by the Tax Court in the case of *Rabinowitz v. Commissioner,* T.C. Memo 2005-188, to find that an aircraft charter activity was operated with the primary purpose of earning a profit and therefore was not subject to the hobby loss limitations.
7. Treas. Reg. § 1.183-1(d)(1). The Regulations further provide that the IRS will generally accept the taxpayer's aggregation of activities unless that aggregation is artificial and unreasonable.
8. *Rabinowitz v. Comm'r,* T.C. Memo 2005-188.
9. T.C. Memo 2005-188.
10. 868 F.2d 833 (6th Cir. 1989), nonacq. 1993-2 C.B. 1. See also *Kuhn v. Comm'r,* T.C. Memo 1992-460.
11. *Misko v. Comm'r,* T.C. Memo 2005-166.
12. *Misko,* T.C. Memo 2005-166 n.8.
13. T.C. Memo 2010-185.
14. The court in *Stangeland* also found that the aircraft was not used in a separate consulting services business to earn a profit, because the taxpayer in Stangeland did not charge his other companies a consulting fee. In contrast, in Richardson v. Commissioner, T.C. Memo 1996-368, the taxpayer was entitled to deduct the expenses of his aircraft when he structured the aircraft operation as part of a management services business that provided management services to his other companies for a management services fee.
15. The court in *Stangeland* distinguished its holding from the holding in Campbell by stating that in Campbell the airplane was leased to "a particular corporation."