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subject: Applicability of Moline Properties to S corporations.

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

In conference calls on 7/20/17 and 8/28/17, we discussed with your office the holding of Peter Morton v. U.S., 98 Fed. Cl. 596 (2011), and its effect of excluding wholly-owned or majority owned S corporations from precedent set by Moline Properties v. Commissioner, 63 S.Ct. 1132 (1943). Based upon the authorities and analysis below, we conclude the Service should reject the Morton holding and continue to assert that Moline Properties is applicable to S corporations, regardless of degree of ownership

ISSUE

Moline Properties stands for the proposition that a corporation created for a business purpose or carrying on a business activity will be respected as an entity separate from its owner for federal tax purposes. Moline Properties predated the enactment of

subchapter S in 1958, but it has been applied to S corporations in several cases. In Morton, however, the Court of Federal Claims concluded that Moline Properties did not apply to S corporations in the context of a § 183 "hobby loss" case, and that the taxpayer was allowed to consider the activities of all of his wholly-owned or majority owned S corporations together as a "unified business enterprise" in determining whether the disputed expenses were attributable to an activity "engaged in for profit." This holding strongly implies that Moline Properties is only relevant in a situation where the taxpayer is attempting to avoid a corporate-level income tax, which is rarely the case because S corporations pass through income and deductions to shareholders. This memorandum discusses the history of the Moline Properties doctrine, as it relates to S corporations. We conclude that Morton is an aberration that the Service should not follow, because Moline Properties is broadly applicable to S corporations, and not just to situations involving a corporate level tax.

LAW AND ANALYSIS

1. **Moline Properties & DuPont**

Moline Properties is the case most cited for the treatment of corporations as entities separate from their owners for tax purposes. A similar holding in Deputy v. DuPont, 308 U.S. 488 (1940), is also cited for the same type of holding.

In Moline Properties, an individual conveyed real estate to a corporation in 1928 as part of a security arrangement at the suggestion of the creditor. The corporation assumed the mortgages, with the individual receiving all the stock which he then transferred to a voting trustee appointed by the creditor. The stock served as security for an additional loan to the individual. That loan was repaid in 1933, with control of the corporation reverting to the individual. The real estate was later sold, with the proceeds received by the individual and deposited in his personal account. The business of the corporation consisted of the assumption of the individual's original obligation to the creditor, the defense of the real estate in a condemnation proceeding, and the institution of a suit to remove deed restrictions from some of the property, though the expenses of the suit were paid by the individual. A portion of the property was also leased as a parking lot. Once the last parcel of real estate was sold, the corporation did not transact any further business, but it was never dissolved. Originally, the loss stemming from the real estate for 1934 and the gain for 1935 were reported on the corporation's return, but the corporation filed a refund claim for 1935 with the individual including the gain on his personal return for that year (and including the 1936 gain on his original 1936 individual return).

The Board of Tax Appeals held for the taxpayer on the grounds that because of the corporation's limited purpose it "was a mere figmentary agent which should be disregarded in the assessment of taxes." 45 B.T.A. 647. The Fifth Circuit reversed, holding that the individual, having formed a corporate entity for reasons sufficient to him, was bound to his choice and the corporation must be recognized for tax purposes. 131 F.2d 388. The Supreme Court affirmed Fifth Court's holding, stating that:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. 319 U.S. 438-39.

The Court did recognize an exception to its general rule when "the corporate form … is a sham or unreal." 319 U.S. 439.

With regard to Moline Properties, the Court found that the corporation had been created by the shareholder for his advantage and served a special function. In particular, since its inception, the corporation was not the shareholder's alter ego, given that he transferred voting control to the creditor and, thus, he did not exercise any control over it. This fact led the Court to state, "It was then as much a separate entity as if its stock had been transferred outright to third persons." 319 U.S. 440.

The shareholder argued the corporation should be disregarded because its creation was "coerced" by the creditors. The Court found that this emphasized rather than vitiated the corporation's separate existence, because "business necessity" made its creation advantageous. Even after the payment of the mortgages led to the control of the stock returning to the shareholder, the corporation continued in existence and engaged in business activities such as the sale of the real estate, and the rental of the parking lot property. In acknowledgment, the Court decided, "The facts … compel the conclusion that the taxpayer had a tax identity distinct from its shareholder." 319 U.S. 440.

DuPont involved a taxpayer who was the largest individual shareholder of a C corporation. In 1919, the corporation created a new executive committee; it was thought desirable for the executive committee members to have a financial interest in the corporation, but for several reasons, it was legally problematic for the corporation to issue shares directly to them. Therefore, the individual shareholder agreed to sell shares to the members, but as he did not have enough shares in his own account to satisfy the obligation, the shareholder instead borrowed additional shares from a related third party, under an agreement to return the shares in ten years and in the interim to pay the lender all dividends paid on the loaned shares. After obtaining the shares, the shareholder then sold the borrowed shares to the executive committee members, the purchase price being furnished by the corporation.

In 1929, near the end of the ten year period, the shareholder did not have enough shares to repay the first lender. In response the shareholder borrowed more shares from a second lender, also a third party, to repay the first lender. The second lending agreement had similar terms to the first borrowing, but added a term whereby the shareholder would reimburse the second lender for all taxes due. These terms resulted in the shareholder paying the second lender approximately $650,000 in 1931,

representing the dividend equivalent and tax reimbursements. The shareholder claimed this $650,000 as a "trade or business" expense deduction under § 23(a), the predecessor to § 162.

The District Court found that the individual shareholder was in the "business" of conserving and enhancing his estate, but that the payments to the lender were not ordinary and necessary expenses of that business because they were not proximately connected with the enhancement of the stock value. The court suggested that even if the shareholder paid the salaries of the corporation's employees directly in hopes of increasing the value of the stock, such costs would not be deductible as business expenses. The opinion also holds that the extraordinary and unusual nature of the payments caused them to fail to be "ordinary," and rejected the taxpayer's alternative characterization of the payments as deductible losses or interest. 22 F.Supp. 589. On appeal, the Third Circuit reversed, agreeing the shareholder was in the business of conserving his estate, but concluding the expenses necessary for him to sell stock to the committee members were in furtherance of that business, even if the sale itself was not specifically for the purpose of profit. 103 F.2d 257.

The Supreme Court reversed the Third Circuit, affirming the decision of the District Court, though without opining on whether the shareholder's activities in conserving and enhancing his estate rose to the level of a business. Instead, the Court concluded that even if the shareholder's payments were in furtherance of his business, it was a business different than that of the corporation. The transactions giving rise to the expenses "proximately result not from the taxpayer's business but from the business of the [corporation] ... The well established decisions of this Court do not permit any such blending of the corporation's business with the business of its stockholders." 308 U.S. 494.

The "separate identity" or "separate entity" principles of Moline and DuPont are regarded as foundational by the courts, the Service, and commentators. See Bittker & Eustice, Fed. Inc. Tax'n of Corps. & Shareholders, at 1.05[1][b] ("In general… the courts follow the principles enunciated in [Moline].") and McKee, et al., Fed. Tax'n Partnerships & Partners, at 3.03 ("In general, the U.S. Supreme Court's seminal decision in [Moline] set the historical substance standard for recognition of corporate entities.")[1]

2. **Morton**

Peter Morton (Morton) was a co-founder of the Hard Rock Cafe restaurant chain. Morton also established the Hard Rock Hotel, Inc. (HRH), a C corporation, which owned and operated the Hard Rock Hotel and Casino in Las Vegas. Morton owned all or most of several S corporations, including Red, White, and Blue Pictures (RWB), Lily Pond

[1] For specific descriptions of Moline or DuPont as "landmark," "seminal," or establishing a general legal principle, see Love v. U.S., 96 F.Supp. 919 (Ct. Cl. 1951), Hagist Ranch v. Comm., 295 F.2d 351 (7th Cir. 1961), Grossman v. Comm., T.C. Memo 1974-269, and In re Homelands of DeLeon Springs, 190 B.R. 666 (U.S. Bankruptcy Ct, M.D. Fla. 1995).

Investments (LP), and 510 Development Corporation (510). RWB owned the real estate underlying some of the Hard Rock Cafe sites and acted as landlord. LP was a holding company with all the voting shares and 94% of the total shares of HRH. 510 performed various other services for the Hard Rock Hotel, such as marketing and public relations, design, management, and accounting, and was also the employment vehicle for Morton's staff.

RWB bought a Gulfstream-III (G-III) aircraft. Morton stated that he purchased the plane through RWB to take advantage of the corporation's limited liability protection. He advanced to RWB all funds used to operate the plane and advanced to 510 all funds used to pay the salaries of its crew. Morton used the plane both for personal travel and for uses which he maintains were related to the business of HRH or more generally "to promote the Hard Rock brand." Morton personally claimed deductions for business use of the G-III for 1999 through 2001 under § 162, as well as depreciation deductions under §§ 167 and 168.[2] The Service challenged these deductions as attributable to an activity not engaged in for profit under § 183 ("hobby losses"). The parties filed cross-motions for summary judgment.

The court summarizes Morton's argument as follows:

> Plaintiff argues that the aircrafts were used to facilitate multiple business activities engaged in by Plaintiff, RWB, and his other business entities, and that such uses are deductible business expenses. In other words, he argues that he is permitted to apply the expenses of an asset owned by one entity towards other entities because Plaintiff and the entities all worked towards a common business purpose, and therefore were all engaged in a common activity for profit. He sets forth a theory that he and his entities operated as a 'unified business enterprise.'

The court accepted Morton's unified business enterprise argument:

> Case law supports Plaintiff's 'unified business enterprise' theory and would allow him to take deductions for aircraft use that furthers the business purposes of entities other than RWB. This deduction may be allowed despite the fact that the aircraft is titled in RWB's name, and RWB did not use the aircraft to further its particular profit motive. As long as Plaintiff used it to further a profit motive in his overall trade or business, the deduction is allowed.

The court relied primarily on two cases to support its conclusion. The first case was Campbell v. Commissioner, 868 F.2d 833 (6th Cir. 1989). In Campbell, substantially all the shareholders of a corporation created a partnership to purchase and lease an

[2] For the later part of this period, he actually claimed deductions for its replacement, a Gulfstream-IV (G-IV). A second issue in the case, which we do not discuss, involves the claimed § 1031 like-kind exchange treatment of the sale of the G-III and purchase of the G-IV.

airplane. The partnership leased the airplane to the corporation for, according to the court, the purpose of generating a profit in the corporation. The airplane was primarily used for the corporation's business, and generated significant tax losses relative to the partner's capital contribution. The 6th Circuit overturned the Tax Court's decision by holding a partner, Dr. Campbell, was allowed to take deductions for the partnership's losses because the partnership was engaged in an activity for profit under § 183. The 6th Circuit allowed Dr. Campbell's deduction based on the "relationship between the partnership and the corporation establish[ing] the requisite profit motive ... The profit motive in these cases need not be isolated and attributed to just the individual or to just the corporation. The *entire economic relationship and its consequences are what determine profit motive*" (emphasis added by the Morton court). 868 F.2d 836-37. The Service did not acquiesce in Campbell. AOD 1993-001, 1993-2 C.B. 1.

The second case is Kuhn v. Commissioner, 64 T.C.M. 488 (1992). In Kuhn, an individual bought land and rented it to his wholly-owned corporation at below-market rates. The corporation had substantial benefit from the land while the individual reported losses from it on his individual returns. The Tax Court found that the individual had a profit motive under § 183 because it was irrelevant whether he intended to "benefit directly (individually) or indirectly (through the corporation)." The Morton court acknowledges that in Kuhn, the taxpayer owned the asset in his own name rather than in that of an entity,

> that difference does not make a distinction. If Plaintiff had titled the aircraft in his name, he would have lost the advantage of limited liability. And since the income, losses, deductions, and credit of S Corporations are passed on to the individual taxpayer, the outcome would have been the same regardless of whether he titled the aircraft in his or RWB's name.

Countering these two cases, the Service argued both DuPont and Moline Properties should apply and the corporation's existence and business purpose must be kept separate from that of the individual taxpayer With regard to DuPont, the court distinguished it from Morton's facts, noting,

> [DuPont] was decided in 1940 and the entity at question was a C corporation with many stockholders. The development of S corporations and other newer types of business entities has changed individuals' relationships with corporations; in an S corporation, the corporation is essentially the individual owner(s). The taxpayer in [DuPont] owned 16% of the stock in the company whereas Plaintiff wholly owns or is a large majority holder of all the entities at issue. The purported business purpose in [DuPont] of 'conserving and enhancing [Plaintiff's] estate is unrelated to [DuPont Corporation's] activity in investment and realty, while Plaintiff's business purpose in traveling to promote the Hard Rock and Morton brands is directly related to the business purposes of all his entities- to further the Hard Rock and Morton brands.

Regarding Moline Properties, just like DuPont, the court made a point of the timing of Moline Properties and the creation of subchapter S: "[a]gain, there are important distinctions between Moline Properties and the facts in our case. Moline Properties was decided in 1943, before the formation of S Corporations."

The court then distinguished Moline Properties from Morton's facts by focusing on the corporate-level tax owned by C corporations, but not (typically) by S corporations,

> The taxpayer in Moline Properties was trying to avoid a corporate-level tax (in addition to the shareholder-level tax), whereas in Plaintiff's case, the corporation is only taxed on the individual level and is not avoiding any other level of taxation.[3] The fact that the Moline Properties court stresses the corporation was not the 'alter ego' of the taxpayer actually supports an outcome in Plaintiff's favor: Plaintiff's entities are 'alter egos' of Plaintiff; they all have the same business purpose.

Although the court found that the facts supported the treatment of Morton's entities as a "unified business enterprise," they did not find enough information in the record to determine which aircraft expenses were for business rather than personal purposes, and therefore deferred judgment on the ultimate allowance of the § 162 and depreciation deductions.

Since the Morton decision, Steinberger v. Commissioner, TC Memo 2016-104, is the only case that cited and discussed Morton. In so doing, the Tax Court distinguished and, thereby limited, Morton's holding. In Steinberger, the Tax Court rejected a taxpayer's argument he should be able to combine the activities conducted by separate entities, an airplane leasing business and medical practice, as a single activity to overcome the § 183 limitation. The Tax Court declined to apply Morton's holding for two reasons. First, the taxpayer in Steinberger and the taxpayer in Morton had significantly different ownership in the entities that each attempted to combine. Specifically, in Steinberger the taxpayer owned approximately 14% of the professional association (i.e., the professional practice) and, with his spouse, 100% of the LLC (i.e., the airplane leasing business). In Morton the taxpayer owned the majority or all of the interest in the corporations he sought to combine. Second, unlike Morton, the taxpayer in Steinberger failed to show the two businesses were a unified business enterprise. Supporting this conclusion the Steinberger court noted that in Morton "the entity that owned the airplane … did more than just own the airplane—it also owned the real property on which several of the Hard Rock Cafes were built and served as landlord of those cafes."

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[3] The court does not mention that an S corporation can have liability for corporate level income taxes in several situations, under §§ 1371(d)(2) (recapture of investment credits under §§ 49(b) or 50(a)), 1374 ("built-in gains" tax on sale of certain corporate property), and 1375 (tax on excess "passive investment income"). As all of these provisions require the S corporation to have had a previous existence as a C corporation or to have previously merged with a C corporation, and do not otherwise appear applicable to the Morton facts, it is unclear whether the court would have found Moline Properties applicable to an S corporation to the extent one of these taxes was implicated.

3. **Historic application of Moline Properties & DuPont to S corporations**

Although there are a number of sources discussing the general "unified business enterprise" theory enunciated in Morton, very few of them specifically analyze the claim that Moline Properties and DuPont do not apply to S corporations (or at least to S corporations that are wholly or mostly owned by a single shareholder). The only detailed discussion we located is "A Rock and a Hard Place: The 'Unified Business Enterprise'" by Professor John Gamino, Tax Notes Today, 8/30/11. Professor Gamino criticizes the Morton decision on several grounds. With respect to the Moline Properties aspect, he states:

> There is no question that Moline Properties remains strong as a general matter—so what is to be made of the view that an S election trumps it, at least in cases of a sole or dominant shareholder? It may seem counterintuitive to treat an S corporation and its shareholder as having separate tax lives, but take such an assumption only a half-step further and one would be left questioning why wholly owned S corporations file returns at all. Why not simply disregard them, the same default treatment applied to single-member LLCs? There is simply no precedent for excluding S corporations from the reach of Moline Properties, and none is cited by the Court of Claims here. The available authority points in the opposite direction—that S corporation status is perfectly congruent with the separation principle. Indeed, no other answer is thinkable in statutory terms—Congress has never limited the subchapter S reporting rigors to corporations having multiple shareholders. [Paragraph break and citations omitted.]

As Prof. Gamino states, prior to Morton, Moline Properties and DuPont had been uniformly applied to S corporations by the courts. In some cases, an S corporation separateness is assumed; in other cases courts consider, and ultimately reject, the position that S corporations might not be treated as separate due to their pass-through nature.

Howell v. Commissioner, 57 T.C. 546 (1972) and Buono v. Commissioner, 74 T.C. 187 (1980) were similar cases involving S corporation's sale of property in which the Service attempted to recharacterize capital gain as ordinary income. The Howell opinion notes that "respondent has not questioned the validity of the corporation structure. Rather, both parties agree that [the S corporation] was a viable corporation. Such an understanding is appropriate in light of the Supreme Court's determination in [Moline Properties]." 57 T.C. 553. In both cases, one of the Service's alternative arguments was to apply the then-existing anti-abuse rule of Treas. Reg. § 1.1375-1(d) under which property that would have produced ordinary income in the hands of the substantial shareholders would do so as well in the hands of an S corporation if the corporation was availed of to change the character. In both, the court found that the regulation was inapplicable because the income would have produced capital gain in the hands of the shareholders (i.e, the shareholders were not "dealers" in that kind of property in their

individual capacities). Because of this, both decisions explicitly avoid opining on the validity of the anti-abuse regulation, but the Buono decision suggests doubt about the regulation because "corporations are almost universally accorded recognition as separate viable entities under the tax law. Moline Properties." 74 T.C. 207.

Crook v. Commissioner, 80 T.C. 27 (1983), involved taxable years of an S corporation governed by the original 1958 provisions of subchapter S, under which S corporation income other than capital gains did not retain its separate character (as is the case for post-1982 S corporations) but was taxable as either an actual or deemed dividend. The shareholders of an S corporation had considerable "investment interest" expense, which they could only deduct against "investment interest" income pursuant to the § 163(d) limits. The Service argued that the S corporation income from the operation of automobile dealerships should be treated as business rather than investment income, and thus should not free up any suspended interest deductions. The court disagreed, finding that the separate existence of the corporation should be respected under Moline Properties and citing to Howell and Buono for the "separate and distinct" business of the corporation from that of its shareholders. Because subchapter S described the income as a "dividend," one of the classic forms of investment income, the interest deductions were allowable against it.[4]

In Allen v. Commissioner, T.C. Memo 1988-166, an individual owned stock in an S corporation which held a partnership interest. The shareholder had insufficient basis in the S corporation stock to claim all of the losses flowing through from the partnership, but argued that his individual guarantees of partnership debts should increase his S corporation basis. The court cited Moline Properties denying the basis and deductions.

Deductions were denied for expenses of an S corporation paid directly by its shareholders in Russell v. Commissioner, T.C. Memo 1989-207. The Service argued that DuPont, among other cases, holds "a taxpayer may not deduct expenses which were incurred for the benefit of others." The taxpayers in Russell argued that these precedents should not apply:

> because, unlike the subchapter C corporations involved in those cases, [S corporation] was a subchapter S corporation. Thus, petitioners reason, even though [S corporation] never paid salaries or dividends the profits would eventually flow to petitioners by operation of law giving petitioners the requisite profit motive. Although all future profits will pass through to petitioners, their profit motive is no greater than that of any subchapter C shareholder. [S corporation] remains a separate taxable entity regardless of whether it is a subchapter S corporation or a subchapter C corporation. It is [S corporation] which 'reaped the income from petitioners' activities, and yet paid none of petitioners' expenses and nothing for petitioners'

[4] Footnote 13 in the Crook decision notes the result would have been reversed under the 1982 revisions, with the active business income retaining its character in the hands of the shareholders.

> efforts in producing the income.' We do not agree with petitioners that a subchapter S corporation should be treated differently from a subchapter C corporation in this respect.[5] [Citations and paragraph break omitted.]

In Amorient v. Commissioner, 103 T.C. 11 (1994), P, a C corporation with several subsidiaries, acquired an S corporation, thereby terminating the S election. P's consolidated return included a net operating loss (NOL), part of which was attributable to the former S corporation. The court found that this portion could not be carried back to P's prior consolidated year, even though such carryback would have been allowed under the consolidated return regulations if the S corporation had instead previously been a partnership, all of the interests in which were acquired by the consolidated group. Despite the similarities between an S corporation and a partnership, the court cited Moline Properties as requiring the former S corporation's corporate status to be respected. Under the relevant portion of Treas. Reg. § 1.1502-79, an acquired corporate subsidiary's post-acquisition NOL could not be carried back to the consolidated group's pre-acquisition return.

Ding v. Commissioner, T.C. Memo 1997-435, *aff'd* 200 F.3d 587 (9th Cir. 1999) discusses whether the income that flow-through an S corporation is treated as self-employment (SE) income for purposes of §§ 1401 and 1402. The taxpayers calculated their SE tax taking into account not only profits and losses from their sole proprietorships and a partnership, but also from several S corporations. For the years in question, the S corporations generated sufficient losses to cause the taxpayers to have negative SE earnings and thus no SE tax. Although the SE statute did not explicitly address S corporations, the court held that the § 1366 income and loss was not an SE item, citing Moline Properties for the separate existence of a legitimate corporation from its shareholder and DuPont for the separate nature of a corporation's business from that of the shareholders. Although § 1366 preserves the nature of S corporation items in the shareholders' hands, this explicitly applies only to chapter 1 of the Code, whereas SE tax is determined under chapter 2.[6]

In Catalano v. Commissioner, T.C. Memo 1998-447, the taxpayer owned several boats which he leased to his wholly-owned S corporation. The court disallowed the corporation's claimed deductions for the lease payments as a § 274 entertainment

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[5] A footnote acknowledges that "[i]f petitioners had allocated the expenses at issue to [S corporation] and had deducted them on [S corporation's] income tax return, the resulting loss would have ultimately passed through to petitioners personally. However, this was not done and cannot help petitioners now."

[6] Durando v. U.S., 70 F.3d 548 (9th Cir. 1995), similarly held that S corporation income was not treated as SE earnings for purposes of calculating a "Keogh" retirement plan deduction. Both Ding and Durando favorably cite Rev. Rul. 59-221, 1959-1 C.B. 225, in which the Service first opined that S corporation income did not constitute SE earnings, although that ruling was under the substantially different provisions of the original subchapter S in which there was no general pass-through of S corporation items, even under chapter 1. In Grigoraci v. Commissioner, T.C. Memo 2002-202, the Service attempted to disregard an S corporation which the individual taxpayer had interposed between himself and a general partnership, and treat the S corporation wages as SE earnings. The court held that the taxpayer's desire to limit his liability was a sufficient business purpose that the S corporation should be respected under Moline Properties.

expense. The taxpayer objected this effectively resulted in double taxation, with the lease payments reportable as Schedule E rental income and the flow-through under § 1366 from the S corporation increased by the disallowance. The court found that this result was compelled by Moline Properties and DuPont:

> In view of these fundamental principles, courts have consistently required shareholders to treat income received as passthroughs from their S corporations as distinct from income the same shareholders received for providing personal services to their corporations. This requirement applies even though the shareholders, and not their corporations, are liable for their pro rata shares of corporate income on their individual income tax returns.[7]

Nelson v. Commissioner, T.C. Memo 2000-212, involved losses of an S corporation which the individual taxpayer had admittedly created as a "shill" for the former owners of a legal gambling business who had been required to divest because of their criminal convictions. The taxpayer did not have sufficient basis in the S corporation stock to claim his losses, but made the argument that the corporation was a "sham" and the losses should instead appear directly on his own return, not subject to basis limitations. The court held that this argument could not be made on certain procedural grounds, but also noted that it would fail under Moline Properties; even if the corporation had been originally created as a sham, it in fact carried on business activities.[8]

One case that might suggest that Moline Properties is not applicable to S corporations is Russon v. Commissioner, 107 T.C. 263 (1996). P was an employee of a C corporation owned by his father and uncles. P and his brothers agreed to purchase the stock of the C corporation from the older generation. P incurred debt to make the purchase, and the issue was whether this was fully deductible as business debt or was subject to the investment interest deduction limits of § 163(d). The Tax Court, citing Moline Properties, concluded that the corporation and its shareholders were separate taxpayers, and that the interest paid by the shareholders to acquire their interests was as part of an investment, not arising out of the corporation's own business. The opinion notes, however,

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[7] In TAM 200214007, IRS Examination unsuccessfully attempted to disregard the existence of S corporations in a § 274 context. A married couple owned all or most of two S corporations, Taxpayer and B. Taxpayer developed and operated Facility, which it rented to B, which deducted the allowable amount of the rents under § 274. Examination questioned the bona fide nature of the payments because of the common ownership of the S corporations, but CC:ITA concluded that given the lack of evidence that either was a sham, Moline Properties and DuPont required that they be respected.

[8] More briefly, the following also apply Moline Properties and/or DuPont to respect the existence of an S corporation: IRS Market Segment Specialization Program Guideline: Passive Activity Losses, Feb. '96 (taxpayers attempting to deduct their payment of corporate expenses on individual returns); Weekend Warrior v. Commissioner, TC Memo 2011-105 (validity of second S corporation formed to provide personnel services to original S corporation); and PLR 201328035 (tax-exempt entity's ownership in S corporation does not cause for-profit activities of corporation to be attributed to owner, which would threaten exemption).

> petitioners fail to consider the fact that [the entity involved here, 'C Corp'] is a C corporation. If [C Corp] were an S corporation or a partnership, it appears that [this partnership], as an active manager, would be entitled to deduct the interest, without limitation, on the debt incurred to purchase the stock as a direct owner of the business. [Citation omitted.]

The distinction between an S corporation and a C corporation under § 163 arises because § 163(d) applies to interest paid on indebtedness allocable to "property held for investment," which § 163(d)(5)(A)(i) defines to include "property which produces income of a type described in § 469(e)(1)." Section 469(e)(1), part of the provision limiting the deduction for losses incurred in "passive activities," includes, in relevant part, "gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business." As C corporation stock is property of a kind which produces dividends, it is investment property, even though the actual stock at issue in Russon had never paid dividends. An S corporation (under current law) usually does not pay dividends but instead passes through the items of income earned by its assets and activities. The published guidance under § 163 applies an aggregate approach to these pass-through entities, allocating the interest among the entities' assets, with that portion belonging to the business assets fully deductible, subject to the passive activity loss limitations under Treas. Reg. § 1.469-2T(d)(3), and that part belonging to the investment assets subject to the § 163(d) limitations.[9]

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[9] Although the similarity of an S corporation to a partnership in the §§ 469 and 163 contexts requires a distinction between the treatment of S and C corporations under those sections, it should be noted that Moline Properties has also been held applicable to partnerships, and therefore the quasi-partnership treatment of subchapter S is not a reason for the non-application of Moline Properties. Briefly, the next three cases extend the Moline Properties principles to partnerships:

Denning v. Commissioner, 180 F.2d 288 (10th Cir. 1950). A corporation was engaged in the business of buying and selling "broom corn" (variety of sorghum used in making brooms) and related products. Several minority shareholders formed a partnership in the same business with their own capital, with no contribution or loan from the corporation or the majority shareholder. Although there were shared employees and facilities, the partnership paid its own share of the expenses and maintained separate records. Citing Moline Properties, the court found that the partnership was valid and could not be disregarded in determining liability for income and excess profits taxes, except with respect to a small portion of its business which was found to be an attempt to evade government price controls (this decision being in the related Denning v. Fleming, 160 F.2d 697 (10th Cir. 1947)). With respect to this small portion, the partnership was the alter ego of the corporation.

Campbell County State Bank v. Commissioner, 37 T.C. 430 (1961), *acq.* 1966-2 C.B. 3, *reversed & remanded on another issue*, 311 F.2d 374 (8th Cir. 1963). The shareholders of a bank formed a partnership to engage in the insurance business because state law forbade banks from engaging in anything other than the banking business. Despite the bank's facilities being used for the insurance business with the bank paying most or all expenses, the Tax Court found that because the insurance partnership did engage in the insurance business, it would be respected under Moline Properties and its income would not be attributed to the bank. The Circuit Court accepted this finding, but held that the Tax Court had not properly allocated expenses between the corporation and partnership under § 482.

There are two narrow exceptions to the general rule that a taxpayer may not deduct an expense paid on behalf of another. The first exception is taxpayers are allowed a deduction for paying another's expense if their primary motive was to protect their reputation or promote their business.[10] The second exception is taxpayers are allowed a deduction if there is a genuine agency relationship between the parties.[11] Although we acknowledge these exceptions, we emphasize the exceptions are narrow and neither attempts to negate Moline Properties.

DISCUSSION & CONCLUSION

As discussed above, there is no support of the Morton theory of the non-applicability of Moline Properties and DuPont to S corporations in prior case law or elsewhere. Prof. Gamino points out the explicit statutory requirements for even a single shareholder S corporation to file a separate return, and such a corporation may even have its own corporate level tax liabilities under some circumstances (see fn. 3), which vitiates the apparent rationale for the Morton distinction between S and C corporations.

Further, there is no justification for treating S corporations differently from C corporations, except to the extent there is specific authorization for doing so under the Code or other precedential authority. See § 1371(a) (subchapter C is generally applicable to S corporations). An example where subchapter S is inconsistent with subchapter C is § 1363(b), which generally provides that the taxable income of an S corporation shall be computed in the same manner as that of an individual. For the application of § 1363(b), see, e.g. Rev. Rul. 93-36, 1993-1 C.B. 187, in which an S corporation was treated like an individual for determining the deductibility of a nonbusiness bad debt under § 166. In contrast to Morton, the list of authorities detailed above, consistently decided before and after the 1982 revisions to subchapter S, clearly

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Bertoli v. Commissioner, 103 T.C. 501 (1994). The taxpayer was the general partner of a partnership to which his brother transferred assets in an attempt to defraud creditors. A state court found that the transfers were fraudulent conveyances and the partnership's assets were placed in receivership. Based on this, the partnership wrote down the value of its assets to zero and the taxpayer claimed losses. The Tax Court found that the state court adjudication could bind the parties in a federal action, and that the taxpayer was estopped from asserting that the partnership was created for a business purpose. However, the taxpayer was not estopped from showing the validity of the partnership under Moline Properties by proving that the partnership actually engaged in any business activities.

[10] See, e.g., Lohrke v. Commissioner, 48 T.C. 679 (1967)(establishing a two-prong test for a shareholder to deduct payment of a corporation's expense: (1) the purpose was to protect or promote the shareholder's own business, and (2) the expenses paid were ordinary and necessary to that business); Capital Video Corp v. Commissioner, 311 F3d 458 (CA1 2002)(a corporation failed to meet the second prong of the Lohrke test because its payment for shareholder's criminal defense were not an ordinary and necessary business expense).

[11] See, Commissioner v. Bollinger, 485 U.S. 340 (1988) (an agency relationship existed and an individual shareholder was allowed to deduct construction and operation expenses despite his corporation holding record title to the improved property).

approve of applying Moline Properties and DuPont to S corporations, as it is consistent with Title 26 and subchapter S.

Excluding S corporations from Moline Properties also creates substantial uncertainties and potentially heavy taxpayer burdens. Even if the Service were to accept Morton for wholly-owned S corporations, it would create a compliance difficulty, as the same corporation and its shareholder(s) would gain or lose eligibility for tax benefits from year to year based on whether or not the corporation was wholly-owned for that year. But Morton's holding would not be limited to wholly-owned S corporations because Morton was described as only a *majority shareholder* in some of the entities which nonetheless were found to be part of the "unified business enterprise." Morton does not offer any standard for determining the threshold level of ownership sufficient to enable taxpayers to claim a unified business enterprise. To administer a Morton rule, the Service would presumably have to adopt, by administrative fiat, some threshold ownership rule, perhaps the "80/80" voting and value test from § 1504(a)(2). But lacking statutory authorization, any such regime would be subject to challenge.

For the reasons above, we conclude that the Service should reject the Morton holding and continue to assert that Moline Properties is applicable to S corporations, regardless of whether the S corporation is wholly or majority owned. If, despite clear law to the contrary, to the extent a court supported Morton's holding, we would also argue Steinberger significantly limits Morton to its facts. Those facts include a shareholder owning at least a majority, if not substantially more, of the entities sought to be combined and that those same entities must have significant business integration.

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