A Trap in the Interest Limit's Small Business Exemption

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In this article, Pisem and Snyder explain how an aggregation rule in the employee benefit plan provisions can unexpectedly prevent some entities from qualifying for the small business exemption from the business expense limitation.

The Tax Cuts and Jobs Act modified the limitation imposed by section 163(j)(1) on the deductibility of business interest and vastly expanded the universe of taxpayers subject to that limitation. Finding their clients relief from section 163(j)(1) has become a daily preoccupation for many tax advisers. One major escape hatch is found in section 163(j)(3), which exempts small business taxpayers — that is, those that meet the gross receipts test of section 448(c) for the tax year. Under section 448(c)(1), a corporation or partnership meets that test if its average annual gross receipts for the three-tax-year period ending with the previous tax year do not exceed $25 million.[1]

Sections 163(j) and 448(c) present a host of interpretive challenges, and the statutory provisions can lead to surprising and counterintuitive results. This article focuses on one narrow area: how an obscure paragraph deep in the code provisions governing employee benefit plans can require the aggregation of entities having only insignificant overlapping ownership, and thereby disqualify taxpayers from the small business exemption.

I. Gross Receipts: Principles of Aggregation

A taxpayer could easily satisfy the gross receipts test and thereby avoid the business interest limitation if it were allowed to divide its business into multiple corporations or partnerships whose respective annual gross receipts were counted separately. As annual gross receipts of one of its entities edged toward $25 million, the taxpayer would only have to form a new entity (possibly under identical ownership and management) to share in the business and absorb sufficient gross receipts to prevent its affiliate from hitting the $25 million limit. To thwart that sort of gamesmanship, the aggregation rule of section 448(c)(2) provides: "All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person" for purposes of paragraph (1).[2]

In other words, the gross receipts of all the persons described in the aggregation rule must be added together.[3] If, in the aggregate, their average annual gross receipts for the three-tax-year period that precedes the tax year at issue exceed $25 million, none of them satisfies the gross receipts test, and

none of them is eligible for the small business exemption from the application of section 163(j)(1) for the tax year.

II. Single Employers Under Section 52

Section 52(a), the first provision incorporated by reference in the aggregation rule, provides that in computing a taxpayer's work opportunity credit, all employees of all corporations that are members of the same controlled group will be treated as employed by a single employer. Section 52(a) defines a controlled group of corporations by reference to the definition in section 1563(a), which in turn encompasses parent-subsidiary controlled groups and brother-sister controlled groups. Section 52(a) makes a material tweak to the definition affecting parent-subsidiary controlled groups, but the scope of a brother-sister controlled group of corporations under section 52(a) is essentially identical to that under section 1563(a).[4]

Section 52(b) provides that under regulations to be prescribed by Treasury "based on principles similar to the principles which apply in the case of subsection (a)" — that is, under the principles of section 1563 — all employees of trades or businesses (regardless of whether incorporated) that are under common control will similarly be treated as employed by a single employer for work opportunity credit purposes. Following that direction, reg. section 1.52-1(d) provides that a brother-sister group under common control for purpose of section 52 means two or more organizations[5] conducting trades or businesses if:

- the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of some rules of constructive ownership[6]), for a partnership,[7] at least 80 percent of the profits interest or capital interest; and
- taking into account the ownership of each such person only to the extent that their ownership is identical for each organization, those persons own more than 50 percent of the capital interest or profits interest of the partnership.[8]

That each of section 52 and section 1563 is incorporated by reference in many other code provisions[9] contributes to many tax practitioners' familiarity with the principles of section 1563. Accordingly, although section 52 does tweak the basic section 1563 rules in the parent-subsidiary context, and although there are circumstances in which the section 52 rules may be ambiguous or lead to incongruous results, the limits to which section 52 permits aggregation to extend can be fairly readily ascertained and are generally well understood.

III. Affiliated Service Groups

Section 52 is not the only provision incorporated by reference in the aggregation rule of section 448(c)(2). That rule also requires aggregation of all persons treated as a single employer under section 414(m),[10] "Employees of an Affiliated Service Group."

Several factors — including the relative clarity of the analysis under section 52 and section 414's place amid the code's pension and employee benefit provisions (often the province of an ERISA specialist) — may tempt practitioners to stop their analysis after determining that aggregation of the gross receipts of two or more business entities is not required under section 52.[11] The seductiveness of this shortcut is enhanced by the fact that the first four paragraphs of section 414(m) are designed to require the aggregation of service organizations (organizations whose principal business is the performance of services) with each other and with other service-providing organizations and have little relevance in other situations.

However, when one carefully reads section 414(m), and especially paragraph (5), it becomes evident that related organizations — particularly brother-sister partnerships — that are not engaged to any extent in the performance of services can still be labeled as members of an affiliated service group and aggregated under section 414(m).

Section 414(m)(1) provides: "For purposes of the employee benefit requirements listed in paragraph (4),[12] except to the extent otherwise provided in regulations, all employees of the members of an affiliated service group shall be treated as employed by a single employer."

The basic definition of affiliated service group is provided in section 414(m)(2) and is satisfied only if, among other requirements, there is at least one service organization, and there is also either at least one additional service organization (for a total of at least two service organizations) or at least one organization a significant portion of the business of which is the performance of services of a type historically performed in that service field by employees. An affiliated service group under section 414(m)(2) includes only service organizations and other service-providing organizations described in section 414(m)(1); organizations that *receive* services from those service organizations and service-providing organizations are not included in the section 414(m)(2) definition.

However, section 414(m)(5) goes further. It provides:

> For purposes of this subsection, the term "affiliated service group" also includes a group consisting of —
>
> (A) an organization the principal business of which is performing, on a regular and continuing basis, management functions for 1 organization (or for 1 organization and other organizations related to such 1 organization), and
>
> (B) the organization (and related organizations) for which such functions are so performed by the organization described in subparagraph (A).
>
> For purposes of this paragraph, the term "related organization" has the same meaning as the term "related person" when used in section 144(a)(3).

Section 144(a)(3)(A) provides that a person is related to another person if the relationship between them would result in a disallowance of losses under section 267 or 707(b).[13]

Section 707(b)(1)(B) disallows deductions for losses from sales or exchanges of property between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.[14] Under the constructive ownership rule of section 267(c)(2) (made applicable to section 707(b)(1) by section 707(b)(3)), an individual is considered to own stock and partnership interests directly or indirectly owned by or for his family. Under section 267(c)(4), the family of an individual includes their brothers and sisters (whether whole or half siblings), spouse, ancestors, and lineal descendants.

The upshot of this string of provisions is this: If (1) two or more partnerships bear the relationship described in section 707(b)(1)(B) — that is, if the same persons directly or indirectly own (giving effect to the constructive ownership rules of section 267(c)) more than 50 percent of the capital interests or profits interests in those partnerships — and (2) there is an organization whose principal business is to perform management functions for those partnerships on a regular and continuing basis, the service-providing organization and the service-receiving partnerships together constitute a single affiliated service group under section 414(m). This means that all their gross receipts must be aggregated for purposes of the small business exemption of section 163(j)(3).[15]

Only the partnerships related to each other for which those management functions are performed are included in the affiliated service group; if a related partnership is not a recipient of those management functions from the service provider, it does not appear to be drawn into the group.[16] However, it is irrelevant whether the service-providing organization is related to any of the service recipients, and it is irrelevant whether the relationship between the partnerships is sufficiently close for them to constitute a group under common control for purposes of section 52.

As discussed later, there are ambiguities in the text of section 414(m)(5) that make it difficult to apply, and that difficulty is enhanced by the fact that regulations thereunder have not been promulgated, even though the provision has been part of the code since 1982. Although the IRS did issue proposed regulations under section 414(m)(5) in 1987,[17] they were withdrawn in April 1993.[18] The main sources of guidance under section 414(m)(5) are its limited legislative history,[19] the withdrawn proposed regulations, and field service advice issued in 1995.[20]

IV. Comparison of Section 52 With Section 707

There are at least six ways in which the rules determining whether two partnerships are related for purposes of section 707(b)(1)(B) are broader than those for determining whether the same partnerships constitute a brother-sister group under common control for purposes of section 52:

1. The family attribution rules of constructive ownership applicable under section 52 are narrower than those applicable under section 707(b).

2. The first test applicable under section 52 requires at least 80 percent overlapping ownership, but section 707(b)(1)(B) requires only more than 50 percent overlapping ownership.

3. Section 52's second test, concerning more than 50 percent overlapping ownership, looks at

that ownership "only to the extent such . . . ownership is identical" for each partnership, but section 707(b)(1)(B) contains no such limitation.

4. For purposes of section 52, overlapping ownership is determined by reference to "five or fewer persons," but section 707(b)(1)(B) looks at all overlapping owners, regardless of their number.

5. The five or fewer persons who are relevant under section 52 must be individuals, estates, or trusts, but section 707(b)(1)(B) looks at all overlapping owners, regardless of their status as individuals, estates, or trusts.

6. Under reg. section 1.52-1(b), an organization may be a member of only one group of trades or business under common control, and if an organization would otherwise be a member of more than one such group, it may choose the group in which it is to be included. No similar rule under section 707(b) restricts the number of other partnerships to which a partnership may be related, even if those other partnerships are not related to each other.

The examples below illustrate these differences, highlighting cases in which section 414(m)(5) requires an aggregation of gross receipts among partnerships that are related for purposes of section 707(b)(1)(B), even though aggregation would not occur under the rules of section 52.[21] In each case, we assume that, except when explicitly stated otherwise, there is some organization "the principal business of which is performing, on a regular and continuing basis, management functions" for the partnerships.[22] (We discuss later the definition and application of the terms "principal business," "regular and continuing basis," and "management functions.") There is no family relationship among any of the individuals appearing in the examples, except as expressly stated.

A. Family Attribution

Example 1: Dick and Jane are brother and sister. Dick owns 51 percent of the interests in Partnership A, and Jane owns 51 percent of the interests in Partnership B. Chris, who is unrelated to Dick and Jane, owns 49 percent of the interests in each partnership.

1. Section 52**.**

The family attribution rules in reg. section 1.414(c)-4(b)(5) and (6) apply for purposes of section 52.[23] Under those rules, an individual is generally considered to own interests owned by his spouse and, under some circumstances, his children, grandchildren, parents, and grandparents. However, those rules do not consider an individual to own interests owned by his siblings. Accordingly, the only overlapping ownership is that of Chris, whose 49 percent interest is insufficient to satisfy either the 80 percent or the 50 percent tests, and partnerships A and B are not members of a brother-sister group under common control for purposes of section 52.

2. Section 707(a)(1)(B).

Because section 707(b)(3) incorporates the constructive ownership rules of section 267(c), Jane is considered to own the interest in Partnership A actually owned by Dick. Accordingly, a single person — Jane — owns more than 50 percent of the interests in each partnership.[24] A relationship exists under section 707(a)(1)(B). (Indeed, such a relationship would exist even if Chris owned 49 percent of Partnership A only, and someone unrelated to Chris, Dick, or Jane owned 49 percent of Partnership B.) The partnerships will be part of a single affiliated service group if there is some organization whose principal business is performing management functions for the two partnerships on a regular and continuing basis.[25]

B. No 80 Percent Test

Example 2: Marie owns 60 percent of the interests in each of Partnership C and Partnership D. Selma owns the remaining 40 percent of the interests in Partnership C, and Pearl owns the remaining 40 percent of the interests in Partnership D.

1. Section 52.

Under the Supreme Court's decision in *Vogel Fertilizer*,[26] an individual's ownership is taken into account in determining whether the overlapping ownership of two organizations satisfies the 80 percent test only if he owns some interest in each of the two organizations.[27] Only Marie owns an interest in each of the partnerships, and she does not own 80 percent of either. Accordingly, partnerships C and D are not members of a brother-sister group under common control for purposes of section 52.

2. Section 707(a)(1)(B).

A single person — Marie — owns more than 50 percent of the interests in each partnership. A relationship exists under section 707(a)(1)(B), and the partnerships will be part of a single affiliated service group if there is some organization whose principal business is to perform management functions for them on a regular and continuing basis.

C. No 'To the Extent' Test

Example 3: John and Mary own 99 percent and 1 percent, respectively, of the interests in Partnership E, and 1 percent and 99 percent, respectively, of the interests in Partnership F.

1. Section 52.

For purposes of the 50 percent test under section 52, an individual's ownership is taken into account "only to the extent . . . identical with respect to each organization." John's identical ownership in each of the two partnerships is 1 percent, and Mary's identical ownership in each of the two partnerships is 1 percent, for a total of 2 percent. Thus, the 50 percent test is not satisfied, and partnerships E and F are not members of a brother-sister group under common control for purposes of section 52.

2. Section 707(a)(1)(B).

Two persons — John and Mary — each of whom owns some interest in each partnership,[28] together own more than 50 percent of the interests in each partnership. A relationship exists under section 707(a)(1)(B), and the partnerships will be part of a single affiliated service group if there is some organization whose principal business is to perform management functions for them on a regular and continuing basis.[29]

D. Five or Fewer

Example 4: Fred, Wilma, Morgan, Abby, Tierna, Crystal, Jozy, Paul, Tyler, and Michael each own a 10 percent interest in Partnership G and a 10 percent interest in Partnership H.

1. Section 52**.**

Even though the ownership of the two partnerships is identical, no group of five or fewer individuals owns an 80 percent interest in either partnership. The 80 percent test is not satisfied, and partnerships G and H are not members of a brother-sister group under common control for purposes of section 52.

2. Section 707(a)(1)(B).

There is no cap on the number of persons who may be taken into account for purposes of section 707(a)(1)(B). A number (in this case, any six) of the individuals owns more than 50 percent of the interests in each partnership. A relationship exists under section 707(a)(1)(B), and the partnerships will be part of a single affiliated service group if there is some organization whose principal business is to perform management functions for them on a regular and continuing basis.

E. Individuals, Estates, or Trusts

Example 5: Abraham and extremely widely held Public Corp., in which no one individual owns an interest of greater than 0.1 percent, own a 79 percent interest and a 21 percent interest, respectively, in each of Partnership I and Partnership J.

1. Section 52**.**

Even though the ownership of the two partnerships is identical, no group of five or fewer *individuals* owns an 80 percent interest in either partnership.[30] The 80 percent test is not satisfied, and partnerships I and J are not members of a brother-sister group under common control for purposes of section 52.

2. Section 707(a)(1)(B).

Corporations are persons for purposes of determining whether the two partnerships are described in section 707(a)(1)(B).[31] In this case, the same two persons own more than 50 percent of the interests in each partnership. A relationship exists under section 707(a)(1)(B), and the partnerships will be part of a single affiliated service group if there is some organization whose principal business is to perform management functions for them on a regular and continuing basis.

F. Multiple Groups

Example 6: Alex owns a 51 percent interest in Partnership X and a 1 percent interest in Partnership Y. Beth owns a 49 percent interest in Partnership X, a 98 percent interest in Partnership Y, and a 49 percent interest in Partnership Z. Charlie owns a 1 percent interest in Partnership Y and a 51 percent interest in Partnership Z.

1. Section 52**.**

Partnerships X and Y satisfy the definition of a brother-sister group under common control, as do partnerships Y and Z. However, the three partnerships do not form a single group,[32] so Partnership Y may choose whether to be included in a group with Partnership X or with Partnership Z.

2. Section 707(a)(1)(B).

Nothing precludes Partnership Y from bearing a section 707(a)(1)(B) relationship simultaneously with each of Partnership X and Partnership Z, even though partnerships X and Z do not bear a section 707(a)(1)(B) relationship with each other. Assuming there is some organization whose principal business is performing management functions for all or a subset of the partnerships on a regular and continuing basis, aggregation of the partnerships into a single affiliated service group (or aggregation of two out of the three partnerships into a single affiliated service group) appears to depend on which partnerships the organization performs management functions for.

If the principal business of the management organization is to perform management functions for partnerships Y, X, and Z on a regular and continuing basis, all three will be aggregated into a single affiliated service group. If the principal business of the management organization is to perform management functions for partnerships Y and X on a regular and continuing basis, only they will be aggregated. Likewise, if the principal business of the management organization is to perform management functions for partnerships Y and Z on a regular and continuing basis, only they will be aggregated. If, however, the principal business of the management organization is to perform management functions for partnerships X and Z on a regular and continuing basis, there will be no aggregation at all.

V. Business of the Management Organization

Section 414(m)(5) applies only if there is "an organization the principal business of which is performing, on a regular and continuing basis, management functions for 1 organization (or for 1 organization and other organizations related to such 1 organization)." Three phrases here beg for elucidation: "management functions," "principal business," and "regular and continuing basis."

A. Management Functions

1. Scope.

The legislative history of section 414(m)(5) contains no guidance on the scope of the term "management functions." However, the withdrawn 1987 proposed regulations read the term extremely broadly. Former prop. reg. section 1.414(m)-5(c)(1) provided:

> For purposes of this section, the term "management functions" includes only those management activities and services historically performed by employees. Management activities and services include determining, implementing, or supervising (or providing advice or assistance in accomplishing any of the foregoing):
>
> (i) daily business operations (such as production, sales, marketing, purchasing, advertising, etc.),
>
> (ii) personnel (such as staffing, training, supervising, hiring and firing, etc.),
>
> (iii) employee compensation and benefits (such as salaries and wages, paid vacations and holidays, life and health insurance, pensions, etc.),
>
> (iv) short- and long-term business planning (such as product development, budgeting, financing, expansion of operations, capital investment, etc.),
>
> (v) organizational structure and ownership (such as corporate formation, stock issues, dividends, mergers and acquisitions, etc.), and
>
> (vi) any other management activity or service.

In flush language, the regulation added to that list "professional services . . . that relate to the activities and services described in this paragraph (c)(1)."[33]

The 1995 field service advice does not discuss the definition of management functions extensively, but it does contain a brief passage suggesting that "marketing, sales contract negotiation, public relations, and promotional activities" might not be management functions. In the absence of any further guidance, the scope of management functions must be considered unresolved, and there appears to be a material risk that the IRS will read the term extremely broadly.[34] Traditional real estate management companies, for example, perform many of the functions enumerated in former prop. reg. section 1.414(m)-5(c)(1).

2. Historical performance.

Although the legislative history provides no guidance on the meaning of management functions, it sets forth an additional standard that must be met before an affiliated service group can be found under section 414(m)(5):

> The conferees intend that the provision is to apply only where the management functions performed by one person for another are functions historically performed by employees, including partners or sole proprietors in the case of unincorporated trades and businesses. For this purpose, the present-law rules relating to affiliated service organizations and to services historically performed by employees in the case of an affiliated service organization are to apply.

Section 414(m)(2)(B)(i), which became part of the code in 1980 — two years before the enactment of section 414(m)(5) — contains rules that apply to organizations for which a significant portion of their business is the performance of services. In that context, the statute refers to the performance of services "of a type historically performed in such service field by employees." Prop. reg. section 1.414(m)-2(c)(3) states: "Services will be considered of a type historically performed by employees in a particular service field if it was not unusual for the services to be performed by employees of organizations in that service field (in the United States) on December 13, 1980."[35]

The withdrawn proposed regulations under section 414(m)(5) incorporated this "historically performed" test, although measured by reference to September 3, 1982, and then added:

> To the extent that a particular business field did not exist on September 3, 1982, whether a management activity or service will be considered historically performed by employees in that particular business field will be determined by analogy to similar business fields in existence on September 3, 1982. . . . [I]f [a particular] management activity or service was ever performed by any employee of a particular organization in [a particular] business field, such management activity or service is a management activity or service historically performed by employees for purposes of applying section 414(m)(5) to that particular organization . . . for the period beginning on the date such management activity or service was first performed by any employee of that organization and ending on the date five years after such management activity or service is no longer performed by any employee of that organization.[36]

If the application of section 414(m)(5) in 2019 is to be governed by these rules, it is necessary to determine whether it was unusual during the early 1980s for services of the type now provided by an organization performing management functions on behalf of another entity to have been performed by employees (including partners and sole proprietors) of businesses in the field of the service recipient. One wonders whether an expert historian of labor economics should be engaged to help make that determination.

B. Principal Business

The legislative history also provides no guidance on how to determine the principal business of an organization. The withdrawn proposed regulations contained an elaborate two-year rolling gross receipts test. They alternatively allowed the commissioner (but not the taxpayer) to decide that the use of gross receipts was not an appropriate method for determining the taxpayer's principal business and to instead make that decision on the basis of all relevant facts and circumstances, including, for example, time spent by individuals in performing management functions.[37]

The discussion of the principal business requirement in the 1995 field service advice highlights the varying facts and circumstances that may be relevant in determining whether the requirement is met, as well as the difficulty of determining the results in any particular situation under a case-by-case test:

> While no single fact or circumstance is determinative, we suggest that if more than 50 percent of the gross receipts of an organization are derived from providing management functions to a single recipient organization, such fact is relevant in determining the existence of the

> management organization's principal business.
>
> . . .
>
> Another relevant factor, depending on the circumstances, is the amount billed the recipient organization by the management company during any year. . . .
>
> The terms of contracts or agreements pursuant to which management functions are performed may provide facts which are relevant to the determination of whether the "principal business" requirement is satisfied.
>
> The amount of time actually spent by individuals performing management functions for a recipient organization is another potentially relevant factor. . . . The weight accorded to any individual fact or circumstance is also dependent on its relevance and pervasiveness.
>
> . . .
>
> To the extent the functions performed by the management organizations are not management functions which were historically provided by employees of the recipient organization, they are not to be included in any analysis of "principal business."
>
> . . .
>
> When the existence of a section 414(m)(5) affiliated service group is to be determined, a determination should also be made as to the organizations related to the recipient organization pursuant to section 144(a)(3).
>
> . . .
>
> If related pursuant to section 144(a)(3) and the "regular and continuing" criterion is satisfied, then the management functions performed by the management organization for the related organization should be factored into the "principal business" analysis.

The term "principal business" is used in a few code sections outside section 414,[38] and authority thereunder may be relevant in determining whether the section 414 test is met in any particular case.[39]

The determination of a management organization's principal business can be all the more difficult if the taxpayer for which management functions are performed does not have or is unable to obtain any information about the management organization's business dealings with other, unrelated organizations. Because the section 414(m)(5) aggregation rules apply even if the management organization is unrelated to the taxpayer, this scenario is probably not unusual. Moreover, the taxpayer may not even know to what extent the management organization performs management functions for organizations related to the taxpayer, given the relatively low threshold for determining relatedness under section 707(a)(1)(B).[40] Therefore, even if it were clear as a legal matter how to determine a management organization's principal business, it may be extremely difficult for a taxpayer to determine, as a factual matter, whether an affiliated service group exists.

C. Regular and Continuing Basis

As noted above, the withdrawn proposed regulations would have combined the principal business and "regular and continuing basis"[41] requirements into a two-year rolling gross receipts test. The 1995 field service advice, however, takes a less formulaic approach:

> While no single fact or circumstance is determinative, we suggest that at a minimum management functions must be performed for at least two years to support a determination that the performance of management functions is on a "regular and continuous basis." . . .
>
> As a practical matter this two-year period consists of the year for which a determination is being made and the immediately preceding year. . . .
>
> The only limitation on the facts and circumstances used to determine "regular and continuous basis" is that they be relevant. The weight accorded to any individual fact or circumstance is also dependent on its relevance and pervasiveness. For example, the existence of contracts or agreements for the performance of management functions may indicate and support a determination of a regular and continuous business relationship, although such fact alone is not determinative in a facts and circumstances analysis.

VI. As If That Weren't Bad Enough

The withdrawn proposed regulations under section 414(m)(5) would apparently have expanded its scope in ways not evident on the face of the statute. We would like to focus on language that would expand the scope of the recipient organization that may be included, along with the service-receiving organization, in a single affiliated service group.[42]

The withdrawn proposed regulations defined the term "recipient organization" as (1) an organization for which management functions are performed, (2) all organizations aggregated with that organization, and (3) all organizations related to any organization identified in categories (1) and (2).[43]

Organizations were to be considered aggregated under section 414(b), (c), (m), and (o).[44] Organizations were to be considered related if they were related persons under section 144(a)(3) and the management organization performed management functions for them both.[45]

Under that provision of the withdrawn proposed regulations, an organization would not need to be related to a service-receiving organization to be treated as a recipient organization. An organization would be treated as a recipient organization even if it was related only to an organization aggregated with a service-receiving organization (that is, an organization in category (2)).

Example 7, which is based on an example in the withdrawn proposed regulations,[46] illustrates the broad scope of the definition of recipient organization.

Example 7: Marie owns 60 percent of the interests in each of Partnership A and Partnership E. Selma owns the remaining 40 percent of the interests in Partnership A, and Pearl owns the remaining 40 percent of the interests in Partnership E. Partnership A owns 80 percent of the interests in

Partnership B, and Martha, an unrelated individual, owns the remaining 20 percent of the interests in Partnership B. (Compare these facts with Example 2.) A single management organization performs management functions for partnerships B and E, but not for Partnership A, on a regular and continuing basis.

Under section 707(a)(1)(B), incorporated by reference in section 144(a)(3), Partnership E is related to Partnership A. Partnership E is not related to Partnership B, in which Marie indirectly owns only 48 percent (60 percent of 80 percent) of the interests. However, because Partnership E is related to Partnership A, which in turn is aggregated with Partnership B,[47] and because the principal business of the single management organization is to perform management functions for partnerships B and E on a regular and continuing basis, it appears that under the withdrawn proposed regulations Partnership E would be treated as part of a single affiliated service group with partnerships A and B, even though Partnership E on its own is unrelated to, and would not be aggregated with, Partnership B.

Further, the facts may be such that partnerships A and B are aggregated into a single affiliated service group *only because* Partnership E is treated as part of that affiliated service group. Suppose that the management organization provides management functions to partnerships B and E sufficient for its principal business to be the provision of management functions to those partnerships. But taking into account only Partnership B or only Partnership E, the management organization does not provide sufficient management functions to either partnership to be treated as being in the principal business of providing management functions to either partnership. In that scenario, if Partnership E were not considered, Partnership A would not be aggregated with Partnership B and treated as part of a single affiliated service group, because there would be no management organization whose principal business is providing management functions to Partnership A and/or Partnership B.[48] Therefore, Partnership A is aggregated with Partnership B in this scenario only because the withdrawn proposed regulations provide that Partnership E may be included with partnerships A and B, thus causing all three partnerships to be treated as a single affiliated service group as a result of the management functions provided to partnerships B and E.

In this way, the withdrawn proposed regulations would effectively have "hybridized" the controlled group concept of sections 52 and 414(b) and (c) with the related-party concept of section 414(m)(5) to produce an aggregation that could not have been reached under any of those provisions alone.

Example 8: Assume the facts are the same as in Example 7, except that Partnership E owns 80 percent of the interests in Partnership F. Rose, an unrelated individual, owns the remaining 20 percent of the interests in Partnership F, and the management organization performs management functions for Partnership F and Partnership B, but not for Partnership E or Partnership A, on a regular and continuing basis.

Intuitively, one may have expected that, as in Example 7, all the partnerships would be treated as a single affiliated service group. However, it appears that even the withdrawn proposed regulations would not have treated the partnerships as a single affiliated service group in this scenario.

Under the language of the withdrawn proposed regulations, for a related organization to be treated as a recipient organization, it would have had to (1) be related to a service-receiving organization or an organization aggregated with a service-receiving organization and (2) receive management functions from the management organization. In Example 8, Partnership E is related to Partnership A, but Partnership E does not receive services from the management organization. Partnership F receives

services from the management organization, but it is unrelated to Partnership A because Marie indirectly owns only 48 percent of the interests in Partnership F. Therefore, neither Partnership E nor Partnership F satisfies the requirements to be treated as part of an affiliated services group with partnerships A and B.[49]

Indeed, depending on the facts, partnerships E and F may not be aggregated together and treated, along with the management organization, as a single affiliated service group.[50] As discussed earlier regarding Example 7, the facts may be such that the management organization performs management functions for partnerships B and F sufficient for its principal business to be the performance of management functions for those partnerships if they are considered together. However, taking into account only Partnership B or only Partnership F, the management organization may not provide sufficient management functions to either partnership to be treated as being in the principal business of performing management functions for the partnership. In that scenario, partnerships E and F would not be treated as part of a single affiliated service group, because there is no management organization whose principal business is performing management functions for Partnership E and/or Partnership F.

VII. Conclusion

Section 414(m)(5) casts a wider net than section 52, resulting in the aggregation of partnerships under section 414(m)(5) when no aggregation is required under section 52(b). Accordingly, taxpayers trying to calculate their gross receipts to determine whether they are small businesses exempt from the application of section 163(j)(1) should be mindful of the section 414(m)(5) rules as well as the section 52 rules. Unfortunately, it is often hard to know if section 414(m)(5) is applicable, in part because of the lack of guidance on the meaning of key phrases used in it, and in part because a taxpayer will often not know all the facts about the management organization's activities relevant to the section 414(m)(5) analysis. A taxpayer that is trying to determine whether it is an exempt small businesses and has multiple holdings that might be aggregated is therefore left in an unenviable position: It can ignore section 414(m)(5) at its peril, or it can choose to try to apply the section 414(m)(5) rules, in which case it will be rewarded with broad, often vague rules and little guidance on how to apply them.

FOOTNOTES

[1] Section 448 generally prohibits any C corporation and any partnership that has a C corporation as a partner from using the cash receipts and disbursements method of accounting. That rule does not apply, however, if the C corporation or partnership meets the gross receipts test.

[2] Section 448(c)(2) was recently incorporated by reference in new section 7803(e)(7), added by section 1001(a) of the Taxpayer First Act, P.L. 116-35, signed into law July 1.

[3] Reg. section 1.448-1T(f)(2)(ii) provides, however, that gross receipts attributable to transactions between persons who are considered a single employer are not taken into account in determining whether the gross receipts test is satisfied.

[4] The section 52 regulations conform to the definition of brother-sister controlled group in section 1563(a)(2) as that definition stood before amendment in 2004. This is consistent with section 1563(f)(5), added to the code by the 2004 amendment, which provides that the pre-amendment version of section 1563(a)(2) continues to apply for purposes of code provisions that incorporate by reference the section 1563 definition of controlled group of corporations.

[5] An organization means a sole proprietorship, a partnership, a trust, an estate, or a corporation. Reg. section 1.52-1(b).

[6] On July 11 the IRS published corrections (T.D. 8179) to reg. section 1.52-1, clarifying that all constructive ownership rules in reg. section 1.414(c)-4, and not only the constructive ownership rule in reg. section 1.414(c)-4(b)(1) (concerning options), are incorporated by reference in reg. section 1.52-1(d)(1)(i). Previously, the correct cross-reference was unclear because of apparent typographical errors. *See* Tony Nitti, "Is There a Mistake in the Tax Law That Changes the Way We Apply the New Interest Limitation Rules?" *Forbes*, Mar. 8, 2019. Even after applying the broader set of constructive ownership rules provided by corrections, however, section 448's reference to section 414(m) expands the scope of aggregation materially beyond any result that would be reached under section 52.

[7] This article focuses primarily on aggregation of partnerships. However, similar issues arise for groups composed solely of corporations (*see infra* note 13) or of a mixture of partnerships and corporations. In determining whether a corporation is a member of a brother-sister group under common control, the section 52 regulations look to whether ownership of the total combined voting power of all classes of stock entitled to vote or of the total value of the shares of all classes of stock meets the 80 percent and 50 percent tests.

[8] In applying the section 52 rules to partnerships (and for purposes of the section 707 rules discussed later), only economic interests in capital and profits are considered; the fact that management and control may be held by partners in a manner disproportionate to those economic interests is ignored.

[9] *See*, *e.g.*, sections 30B, 59A, 199A, and 465 (incorporating by reference both sections 52 and 1563); sections 38, 41, 52, 144, 147, 162, 179, 194, 249, 263A, 267, 368, 384, 401, 404, 409, 414, 465, 501, 585, 613A, 831, 848, 993, 1202, 3132, 5001, 5051, and 5061 (incorporating only section

1563 by reference (in some cases, with modifications)); and sections 42, 45A, 45E, 45F, 51, 101, 167, 264, 280C, 448, 453A, 455, 856, 1355, 1397, 4182, 5000, and 6053 (incorporating by reference only section 52). Of all these, only sections 30B and 199A also incorporate section 414(m) by reference. By contrast, incorporations by reference of section 414(m) only, but of neither section 52 nor section 1563, appear only in sections 72, 105, 416, and 4977.

[10] Section 448(c)(2) also refers to section 414(o), which authorizes Treasury to prescribe regulations to prevent the use of affiliated groups and other arrangements to avoid employee benefit requirements. For purposes of this report, we ignore section 414(o) and the 1987 proposed regulations under that section (EE-111-82), a portion of which remain outstanding.

[11] Indeed, practitioners whose clients engage in capital-intensive businesses such as real estate may be tempted to avoid the aggregation analysis entirely, given that real estate and farming businesses can elect under section 163(j)(7) to be excepted from the application of section 163(j)(1). However, there is a toll charge for making that election: mandatory use of the alternative depreciation system. So even businesses that qualify for the section 163(j)(7) election might prefer to be exempt under the small business rules.

[12] Those requirements are section 401(a)(3), (4), (7), (16), (17), and (26); section 408(k) and (p); and sections 410, 411, 415, and 416.

[13] Section 144(a)(3)(B) provides that a corporation is a related person to another corporation if the corporations are members of the same controlled group (as defined in section 1563(a), with some modifications). *See supra* note 7. Separate from that rule, section 267 incorporates by reference a version of the section 1563 test, but it is not entirely clear whether that portion of section 267 applies for purposes of section 144(a)(3)(A). Parsing the chain of statutory cross-references beginning in section 52 and those beginning in section 414(m)(5) relevant to groups composed solely of corporations is beyond the scope of this report.

[14] Parent-subsidiary relationships between partnerships that may exist under section 707(b)(1)(A) are beyond the scope of this report.

[15] Section 267(a) disallows deductions for any loss from the sale or exchange of property between persons specified in section 267(b). That includes a sale or exchange between a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest or profits interest in the partnership. Section 267(b)(10). Thus, a group composed of at least one corporation and at least one partnership

may similarly be subject to section 414(m)(5) as a result of the chain of references through sections 144 and 267, regardless of whether it constitutes a group under common control for purposes of section 52.

[16] Under the language of section 414(m)(5), it is unclear whether an organization related to the organization for which the management functions are performed is included in the group under the management function rules. The conference report for the 1982 Tax Equity and Fiscal Responsibility Act says the related organization is included "if the management functions are also performed, on a regular and continuous basis, for such related organization." H.R. Rep. No. 97-760, at 632 (1982) (Conf. Rep.). However, the blue book for TEFRA omits the quoted language, perhaps implying that an organization may be treated as related to a service recipient organization even if no management functions are performed for that related organization. Joint Committee on Taxation, "General Explanation of Tax Equity and Fiscal Responsibility Act of 1982," JCS-38-82, at 324 (1982).

[17] EE-111-82. The preamble to the proposed regulations is not elucidative.

[18] The notice (CO-53-92) said only that the IRS was withdrawing "certain proposed regulations which there are no current plans to finalize"; it did not explain why there were no such plans. *See also* "Request for Comments on Regulatory Burden Reduction Initiative," 57 F.R. 11277 (Apr. 2, 1992). Proposed regulations under the portions of section 414(m) other than section 414(m)(5) were not withdrawn and have been outstanding in proposed form since 1983. However, the third quarter update to the 2018-2019 priority guidance plan, released June 17, includes an item for "guidance regarding the aggregation rules under section 414(m)."

[19] *See* H.R. Rep. No. 97-760, at 631-632; and JCS-38-82, *supra* note 16, at 324.

[20] FSA 2948 (Aug. 30, 1995).

[21] We have generally limited each example to illustrating one of the ways in which a relationship may exist under section 707(b)(1)(B), even though there is no group under common control for purposes of section 52. A section 707(b)(1)(B) relationship can exist even when several of these factors are present simultaneously.

[22] If there is no such organization, section 414(m)(5) will not apply. This could be the case if, for example, each partnership performed 100 percent of its own management functions, or if the

organization that performed management functions for one partnership was not, and was unrelated to, the organization that performed management functions for the other partnership.

[23] *See* reg. section 1.52-1(d)(1)(i). *See also supra* note 6.

[24] The same can be said of Dick.

[25] In each of these examples, the organization performing management functions will also be a member of the group.

[26] *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982).

[27] *See* T.D. 8179, which deleted the words "singly or" from reg. section 1.52-1(d)(1)(i) to conform to the Supreme Court's decision in *Vogel Fertilizer*.

[28] The requirement that each person whose ownership is taken into account own some interest in each partnership is not stated explicitly in section 707(a)(1)(B) or its regulations. In the absence of that requirement, however, all partnerships would be related under section 707(a)(1)(B) to all other partnerships, which is obviously an absurd result.

[29] The result would be the same even if Mary owned only a 50 percent interest in Partnership F, with the remaining 49 percent interest being held by an unrelated third party.

[30] Rules of constructive ownership, if otherwise applicable, would encompass only shareholders of Public Corp. who owned 5 percent or more in value of the stock of the company. Reg. section 1.414(c)-4(b)(4). In this case, there would be no brother-sister group under common control even if the 5 percent threshold for constructive ownership were ignored.

[31] Section 7701(a)(1).

[32] Among other reasons, the "to the extent" requirement prevents the 50 percent test from being satisfied.

[33] The rule was proposed to be even more expansive when the service recipient organization was itself a provider of professional services to third parties. Prop. reg. section 1.414(m)-5(c)(1) (withdrawn 1993).

[34] The term appears in section 7873(b)(3)(A)(iv) (one requirement for status as a qualified Indian entity is that substantially all the management functions of the entity be performed for members of qualified Indian tribes) and, in a somewhat different context, in section 41(d)(4)(D)(ii).

[35] *See* prop. reg. section 1.414(m)-2(c)(8), Example 4; Rev. Rul. 81-105, 1981-1 C.B. 256; and LTR 8521114.

[36] Prop. reg. section 1.414(m)-5(c)(2) (withdrawn 1993).

[37] Prop. reg. section 1.414(m)-5(b) (withdrawn 1993).

[38] Sections 142(l)(4)(A)(vi), 144(c)(6)(B), 147(e), 461(k)(2)(D), 832(b)(1)(D), 851(b)(3), and 864(c)(4)(B)(ii).

[39] *See*, *e.g.*, GCM 37309 (Nov. 2, 1977) (considering whether a factory mutual insurance company could be engaged in a principal business of issuing policies described under former section 831(a)(3)(B)).

[40] For example, assume that Investor W owns (1) a more than 50 percent interest in Limited Partnership A, of which the managing general partner (and sole other partner) is Developer X; and (2) a more than 50 percent interest in Limited Partnership B, of which the managing general partner (and sole other partner) is Developer Y. Even if Investor W is completely unrelated to both Developer X and Developer Y, and Developer X is completely unrelated to Developer Y, Limited Partnership A would still be related to Limited Partnership B under section 707(a)(1)(B).

[41] Somewhat similar phrases appear in sections 469(h)(1)(A) and 1061(c)(2) ("regular, continuous, and substantial" basis) and sections 953(e)(7)(B) and 954(h)(7)(B) ("regular and continuous transactions").

[42] Prop. reg. section 1.414(m)-5(a)(3) (withdrawn 1993) would have expanded the identity of the management organization in a single affiliated service group to include organizations aggregated under other provisions of section 414 with that management organization, as long as the principal business of those other organizations was to perform management functions for the recipient organization on a regular and continuing basis. Both the conference report and the blue book for TEFRA contain language similar to that rule.

[43] Prop. reg. section 1.414(m)-5(a)(4) (withdrawn 1993).

[44] Prop. reg. section 1.414(m)-5(a)(5) (withdrawn 1993). To avoid circularity, the reference to section 414(m) is presumably to the paragraphs other than (5).

[45] Prop. reg. section 1.414(m)-5(a)(4)(i) and -5(a)(6) (withdrawn 1993). Prop. reg. section 1.414(m)-5(a)(4) (withdrawn 1993) does not contain language requiring that management functions be performed for the organization related to a service-receiving organization in order for the related organization to be treated as part of the same affiliated services group. However, prop. reg. section 1.414(m)-5(a)(6) (withdrawn 1993), read closely, does contain such a requirement. *See supra* note 16.

[46] Prop. reg. section 1.414(m)-5(a)(7), Example 2.

[47] For employees of a controlled group of corporations, section 414(b) defines a controlled group of corporations by reference to section 1563(a). Section 414(c) in turn provides that under regulations to be prescribed by Treasury "based on principles similar to the principles which apply in the case of subsection (a)" — that is, under the principles of section 1563 — all employees of trades or businesses (regardless of whether incorporated) that are under common control will similarly be treated as employed by a single employer. Therefore, because Partnership A and Partnership B constitute a parent-subsidiary group under common control, under section 1563 principles, they are aggregated under section 414(c).

[48] For purposes of sections 448 and 163(j), Partnership A and Partnership B would be aggregated in

any event under section 52(b).

[49] The result is the same if partnerships A and B are analyzed first. Partnership A is related to Partnership E, but Partnership A does not receive services from the management organization. Partnership B receives services from the management organization but is not related to Partnership E because Marie indirectly owns only 48 percent of the interests in Partnership B.

[50] For purposes of sections 448 and 163(j), partnerships E and F would be aggregated with each other in any event under section 52(b), but that aggregation rule would not be sufficient to require them to take into account the gross receipts of the management organization in addition to their own aggregated gross receipts.

END FOOTNOTES