“New reporting rules for passive activities force group decisions”

A part of the IRS’s continuing efforts to require greater disclosure of tax positions and strategies on returns, it recently released new, mandatory disclosure rules for grouping passive activities. Rev.Proc. 2010-13 for the first time mandates that passive-activity grouping and regrouping, as required under Code Sec. 469 regulations, be disclosed on the taxpayer’s return.

The IRS, of course, puts a positive spin on this new reporting requirement, claiming that it will help taxpayers “more easily verify their historical groupings.” It also seems clear, however, that the IRS will not put this new information in a drawer, but will use it as an effective audit and compliance tool.

MANDOTORY DISCLOSURE AUTHORITY

Sec. 469 generally prohibits losses incurred in a passive activity from being used to reduce income from an activity that is not a passive activity. A limited exception applies upon the disposition of and activity. Unused passive losses may be carried forward only. A passive activity for these purposes is generally any activity involving the conduct of a trade or business in which the taxpayer does not materially participate, and any rental activity. Grouping activities can be especially significant when determining whether material participation exists.

Sec. 469 defers to regulations the formation of the requirements fro grouping activities. The regs, in turn, leave the rules for identifying particular groupings to the IRS Notice 2008-64, which proposed certain reporting requirements, was the IRS’s first pass at following through on that authority. Rev. Proc. 2010-13 now spells out final reporting requirements.

WHAT THE REGIS ALREADY DO

Passive-activity loss regs (1.469-4 et seq.) treat one or more trade or business activities or rental activities as a single activity if the facts and circumstances indicate that they constitute an appropriate economic unit for the measurement of gain or loss. Facts and circumstances in making that assessment include "any reasonable method," but generally should consider certain nonexclusive factors set out in the regs, including: similarities and differences in types of businesses; the extent of common control; the extent of common ownership; geographical location; and inter-dependencies between the activities.

The regs recognize that the same facts and circumstances may result in more than one permissible grouping of activities, and there may be more than one reasonable method for grouping a taxpayer's activities. However, multiple options do not remain open-ended.

- **Lock in.** Once the taxpayer decides on a grouping, the regs limit change. Reg. 1.469-4 (e) provides that:

  "(1) Original groupings. Except as provided in paragraph (e)(2)…, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years… .

  "(2) Regroupings. If it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities…"

- **Tax avoidance override.** The regs also empower the IRS to regroup a taxpayer's activities if any activity is not an appropriate economic unit, and if a principal purpose of the grouping is "to circumvent the underlying purposes of Section 469" (Reg Sec. 1.469-4(f)). Moreover, the IRS is specifically authorized to impose 6662 penalties in addition to regrouping under such circumstances. The IRS indicated back in 1994 when issuing this reg that it would not exercise its regrouping authority often. Whether having the advantage of disclosures under the new reporting regime will change this dynamic, however, is yet to be determined.

NOTICE 2008-64 PROPOSALS

The regulations under 1.469-4 mandate that taxpayers comply with disclosure requirements "that the commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen grouping in subsequent taxable years."

In floating reporting requirements for comments in Notice 2008-64, the IRS noted that at the time it had not previously prescribed requirements for Sec. 469 groupings, despite this long-time option to do so. It added, however, that, "as a result, the IRS and taxpayers have had difficulty verifying taxpayers' historical groupings." Rev. Proc. 2010-13 now fills that void with a reporting regime similar, but not identical to, that proposed in 2008.

REV. PROC. 2010-13 DISCLOSURES

First, the good news. There are two tax-friendly differences between the Notice 2008-64 proposals and Rev.Proc. 2010-13's requirements. Disclosure will not be required whenever there is a disposition of an activity within a chosen grouping. And a taxpayer with an incorrect grouping has a change to fix the problem without being forced to forego grouping entirely. As a bonus, Rev.Proc. 2010-13 provides that groupings that are made for tax years beginning before Jan. 25, 2010, are required to be disclosed only upon the addition of new activities to existing groups or regroupings therefore need not be disclosed until the 2012 tax-filing season on 2011 returns.

Despite backing off a bit on Notice 2008-64 proposals, however, Rev.Proc. 2010-13 nevertheless, for the first time, will provide the IRS with a significant amount of information heretofore unavailable to assess the necessity and effectiveness of a possible audit on passive-activity groupings.

Taxpayers now must file a written statement with their original income tax returns for the first tax year in which two or more trade or business activities or rental activities are originally grouped as a single activity. The statement must identify the names, addresses and employer ID numbers for the activities that are being grouped. It must contain a declaration that the grouped activities constitute "an appropriate economic unit."

Statements also are required for the addition of new activities to existing groupings and for regrouping of original groupings:

- **Additions.** The taxpayer is required to report on their annual return those changes that occur during the tax year in which the taxpayer adds a new trade or business activity or a rental activity to an existing grouping.
- **Regroupings.** Original groupings that were or have become "clearly inappropriate" must be regrouped and reported as such with the taxpayer's

original tax return for the tax year in which the regrouping occurs. This statement must contain a declaration that the regrouped activities constitute an appropriate economic unit and an explanation of why the original grouping was or is now clearly inappropriate.

The new reporting rules do not alter the restrictions places under the regs on a taxpayer for regrouping. As discusses, once the taxpayer has grouped activities, they normally may not be regrouped in subsequent years unless the original grouping was “clearly inappropriate” pr a material change in facts and circumstances now makes it “clearly inappropriate.” In the case of “clearly inappropriate,” the regs require the taxpayer to make the regrouping and the new procedure sets out the information that must be reported.

- **Passthroughs.** Special disclosure rules apply to partnerships and S corporations. These entities already must comply with the disclosure instruction for grouping activities found on Form 1065, U.S. return of Partnership Income, and Form 1120S, U.S. Income Tax Return for an S Corporation. In general, the entity’s groupings must be disclosed to the partners or shareholders by separately stating the income or loss from each grouping on an attachment to the entity’s annual Schedule K-1. The new reporting procedure makes clear that activities that are grouped together by these Sec. 469 entities may not be treated as separate activities by the shareholder or partner.

SANCTIONS

The failure to report whether activities have been grouped as a single activity will generally result in the unreported activities being treated as separate activities under a default rule. The IRS, however, is not bound by this “separate activities” default rule if it would aid in tax avoidance. Specifically, the IRS may regroup activities to prevent tax avoidance.

A taxpayer who discovers a failure to disclose, too, is not necessarily locked into separate activities treatment. The taxpayer will be deemed to have made a timely disclosure, provided all affected income tax returns have been made consistent with the claimed grouping and the disclosure is made on the return for the year that the failure to disclose is first discovered. In addition, reasonable cause for the failure to make a timely disclosure must be demonstrated by the taxpayer if the IRS first discovers the failure to disclose.

CONCLUSION

Grouping and regrouping of passive activities will be rising to a new level of scrutiny as the IRS gains easy access to information on how closely taxpayers are following the rules under the regs. Taxpayers, too, should take this as a wake-up call to make careful decisions on initial grouping elections and then substantiate those decisions through documentation to show “an appropriate economic unit.” Documentation also should be collected contemporaneously when changed circumstances make an original grouping “clearly inappropriate,’ or “reasonable cause” is raised as a reason for a failure to report.