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New grouping disclosure rules

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The Internal Revenue Code provides that deductions from passive businesses or rental activities generally may only offset income from other passive activities (exclusive of portfolio income). Upon a taxpayer's disposition of his entire interest in a passive activity, any suspended losses are treated as nonpassive and are not subject to these limitations. A dominant tax planning goal, therefore, is to create passive income and nonpassive loss. This goal is restricted by rules requiring taxpayers to identify separate "activities" which, unfortunately, do not permit taxpayers with the benefit of hindsight to regroup activities in a later year simply to maximize deductions. Careful planning is crucial to prevent whipsaw (i.e., one activity with passive losses and another with nonpassive income). For example, a broad grouping of operations into a single activity may preserve the possibility that the profits from one operation will be sheltered with losses of the other. However, if only the unprofitable operation is subsequently disposed, the broad grouping may prevent deduction of any suspended losses because of the disposition rules.

Currently, there is no affirmative statement required to be filed to report a taxpayer's activity groupings. Compliance with the grouping rules is enforced on audit of a taxpayer's return. Revenue agents auditing a particular return are instructed to check later years' returns for consistency of a taxpayer's groupings. This may change as the IRS recently proposed rules for disclosing activity groupings. A taxpayer would be required to file a written statement with his original return for the first tax year in which one or more businesses or rental activities are grouped as single or separate activities. A similar statement would be required for changes to an existing grouping, such as addition of a new activity, disposition of an activity, or a regrouping because it is determined that the original grouping was clearly inappropriate or a material change in facts or circumstances has made the original grouping inappropriate. The change would be effective on the date the IRS publishes final guidance.

Juliette Pico is an attorney with Lourie & Cutler, Boston, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540