November 17, 2008

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments in Response to Notice 2008-64

Dear Commissioner Shulman:

Enclosed are comments in response to Notice 2008-64. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William J. Wilkins  
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service  
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS IN RESPONSE TO NOTICE 2008-64

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jeanne Sullivan. Substantive contributions were made by Daniel J. Carmody, James Gergurich, and AnnMarie Johnson. Helpful comments were made by Paul Kugler, Deborah Swann, Deborah Karet, and Marie Byrne. The Comments were reviewed by Bryan T. Camp, Chair of the Section’s Individual and Family Taxation Committee, R. Brent Clifton, Chair of the Section’s Partnerships and LLCs Committee, Walter Burford, the Section’s Council Director for the Individual and Family Taxation Committee, William H. Caudill, the Section’s Council Director for the Partnerships and LLCs Committee, and Richard M. Lipton of the Section’s Committee on Government Submissions.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: November 17, 2008
EXECUTIVE SUMMARY

Notice 2008-64 requests comments on a proposal to add a new reporting regime to the existing grouping and reporting framework of the passive activity rules under section 469. These Comments summarize the manner in which grouping activities affects potential tax liabilities under section 469, discuss the proposal described in the Notice, suggest an alternative approach as a means to avoid unnecessary and potentially burdensome disclosures, and describe the appropriate treatment of a failure to disclose.

We suggest that targeted grouping disclosures be required of the persons who are described in section 469(a)(2) (“Covered Persons”) in situations in which the grouping of activities affects the Covered Person’s tax liabilities. In general, grouping disclosures would be required when activities are grouped for purposes of the material participation test, when the disposition of a passive activity allows a Covered Person to treat a suspended passive loss as nonpassive, and when a Covered Person changes a disclosed grouping. Disclosures would not be required of entities that are not Covered Persons. Finally, a default grouping based upon a Covered Person’s failure to disclose as required would be only a presumption that could be overcome by evidence of consistent treatment by the Covered Person.

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2 All references to sections herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to Regulations are to the Treasury Regulations issued under the Code.
DISCUSSION

Background

Section 469(a)(1) provides that neither a passive activity loss nor a passive activity credit shall be allowed to an individual, estate, trust, closely held C corporation, or personal service corporation (a “Covered Person”).\(^3\) The rules for determining whether a Covered Person has a passive activity loss or a passive activity credit effectively require all of a Covered Person’s trade or business activities to be viewed through the filter of the passive activity rules of section 469 and its regulations. The passive activity rules, among other things, identify what constitutes a passive activity, define items that are treated as passive or non-passive, and provide rules for allocating income, deduction, and credit between passive and non-passive activities.

Generally, the rules allow losses from passive activities (in the aggregate) to offset income from passive activities (in the aggregate) for purposes of determining whether a Covered Person has a net passive loss for the taxable year that is suspended under section 469(a)(1). A passive activity loss that is suspended under section 469(a)(1) must be allocated among the Covered Person’s passive activities in proportion to the losses from activities that generate losses.\(^4\)

A passive activity is defined as any trade or business activity in which the taxpayer does not materially participate\(^5\) and, except as provided in section 469(c)(7) with respect to certain real estate professionals,\(^6\) any rental activity.\(^7\) For this purpose, a trade or business activity\(^8\) is defined to include research and experimentation activity.\(^9\) Special rules also provide for both the inclusion and exclusion of certain activities from the passive activity rules regardless of whether the activities would otherwise constitute a trade or business or whether the taxpayer materially participates in the activity. For example, a working interest in any oil and gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to that interest is not a passive activity (without regard to whether the taxpayer materially participates),\(^10\) and the activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether the activity is a trade or business activity).\(^11\)

Regulation section 1.469-4(c) generally permits the grouping of trade or business activities into a single activity if the activities constitute an appropriate economic unit for

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\(^3\) Section 469(a)(2).
\(^5\) Section 469(c)(1), Temp. Reg. § 1.469-1(e)(1)(i).
\(^6\) See Reg. § 1.469-9.
\(^7\) See Section 469(c)(2), Temp. Reg. §§ 1.469-1(e)(1)(ii), -1(e)(3).
\(^8\) Section 469(c)(6), Temp. Reg. §§ 1.469-1(e)(2), -1(e)(2), -4(b)(1). Section 469(c)(6)(B) provides that, to the extent provided in regulations, the term “trade or business” includes any activity with respect to which expenses are allowable as a deduction under section 212. However, regulations have not been issued to implement this section.
\(^9\) Section 469(c)(5), Reg. § 1.469-4(b)(1)(iii).
the measurement of gain or loss for purposes of section 469.\textsuperscript{12} Except to the extent otherwise provided by the regulations, whether activities\textsuperscript{13} constitute an economic unit and, therefore, may be treated as a single activity depends on all the relevant facts and circumstances.\textsuperscript{14} Also, a taxpayer may use any reasonable method of applying the facts and circumstances in grouping activities.\textsuperscript{15}

Corporations subject to section 469, partnerships, and S corporations (each a “Section 469 Entity”)\textsuperscript{16} must group their activities under the rules of section 469 and, once grouped, a partner or shareholder may group those activities with each other, with activities conducted directly by the partner or shareholder, and with activities conducted through other Section 469 Entities.\textsuperscript{17} A partner or shareholder may not treat the activities grouped together by a Section 469 Entity as separate activities.\textsuperscript{18}

\textit{Notice 2008-64 Proposal}

Notice 2008-64 requests comments on a proposal to add a new reporting regime to the passive activity rules’ existing grouping and reporting framework. The Internal Revenue Service (the “Service”) indicated in Notice 2008-64 that this proposal is one possible approach, and also stated that it is interested in other possible approaches. The proposed reporting regime would require taxpayers to file a written statement with their original tax return for the taxable year in which one or more trade or business activities or rental activities are (i) originally grouped, (ii) added to an existing group, (iii) disposed of from an existing group, or (iv) regrouped because the original grouping was determined to be clearly inappropriate or there had been a material change in the facts and circumstances that made the original grouping clearly inappropriate.

In Notice 2008-64, the Service stated that there were no prescribed reporting requirements for taxpayer groupings under section 469, other than those provided in Regulation section 1.469-9(g) (relating to the election available to certain real estate professionals). Consequently, the Service and taxpayers have had difficulty verifying taxpayers’ historical groupings, presumably on examination. The proposal described in Notice 2008-64 would provide a reporting system that seeks to address this issue without unduly burdening taxpayers. In this proposal, the Service presents one method for determining the groupings of taxpayers for purposes of section 469 so that such groupings can be identified on examination.

\textsuperscript{12} Reg. § 1.469-4(c)(1).

\textsuperscript{13} The regulations use the terms “activity” and “activities” in two distinct senses, first in the sense of the basic building blocks that are grouped together to form, in the second sense, the operating concept of an activity to which the passive rules actually apply. See Daniel N. Shaviro, \textit{Passive Loss Rules}, 549-2\textsuperscript{nd} Tax Mngt. Port. (BNA), A-10.

\textsuperscript{14} Reg. § 1.469-4(c)(2).

\textsuperscript{15} \textit{Id}.

\textsuperscript{16} Partnerships and S corporations are not Covered Persons, but they may be owned by Covered Persons.

\textsuperscript{17} Reg. § 1.469-4(d)(5).

\textsuperscript{18} \textit{Id}.
When Disclosure of Groupings Should Be Required

Because of the passive activity rules’ broad application and complicated grouping provisions, the myriad arrangements through which trade or business activities are conducted, and the natural changes in the facts and circumstances relating to a Covered Person’s ownership and participation in trade or business activities, we believe it is not reasonable to expect taxpayers, especially taxpayers not represented by tax professionals who are well versed in the passive activity rules, to comply with the disclosure requirements described in Notice 2008-64. Despite the Service’s suggestion in the Notice that its reporting proposal would address the “difficulty [of] verifying taxpayers’ historical groupings … without unduly burdening taxpayers,” we respectfully submit that the proposal would be administratively cumbersome and expensive for both taxpayers and the Service. Moreover, excessive reporting can hinder more than it facilitates enforcement.19

We support the Service’s proposal to require grouping disclosure in the following three circumstances and believe these targeted disclosure requirements would improve compliance with the requirements of section 469. We also believe that disclosure of these items in an amended return should satisfy disclosure requirements, particularly if the Covered Person is not under examination when the amended return is filed.

1. Material participation test. A Covered Person may group activities for purposes of satisfying the material participation test under Regulation section 1.469-5 so the activity may qualify as non-passive. Disclosure would be appropriate at the time of the formation of a new grouping or the addition of a new activity to an existing grouping when that grouping is used by a Covered Person to satisfy the material participation test.

2. Disposition of a passive activity. A Covered Person may recognize a suspended passive loss upon the disposition of an entire interest in an activity20 or the disposition of substantially all of an activity.21 Disclosure would be appropriate at the time of such a disposition that allows a Covered Person to treat a suspended passive loss as non-passive.

3. Regrouping. Finally, disclosure would be appropriate when a Covered Person changes a disclosed grouping upon a determination that its original grouping was clearly inappropriate or that there has been a material change in circumstances that made the original grouping clearly inappropriate.

Who Should Disclose

In balancing the Service’s need for information with the burden imposed on taxpayers, we believe that section 469 grouping disclosure to the Service should be required only of Covered Persons. If a Covered Person conducts an activity through a partnership or S corporation, those entities are not Covered Persons, but their grouping

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19 We are interested in the results of any attempt to quantify the number of taxpayer filings that could be expected if the disclosure proposal made by Notice 2008-64 were finalized. We are concerned that the increased complexity of the proposed new reporting regime combined with additional disclosures may result in more, but less reliable, information than is presently provided.

20 Section 469(g).

21 Reg. § 1.469-4(g).
choices will have already potentially limited the grouping options available to their equity owners pursuant to Regulation section 1.469-4(d)(5). In the case of equity owners who are certain real estate professionals, their grouping choices will have been dictated by the grouping rules under Regulation section 1.469-9(h). This type of disclosure redundancy seems unnecessary, particularly because the partnership’s grouping of its activities should be clear from the manner in which the partnership currently provides information to its partners each taxable year. After the partnership’s grouping is communicated to its partners, the partner who is a Covered Person can then make the required disclosures (described above) when the grouping is relevant to that person’s tax liabilities.

**Default Groupings**

Notice 2008-64 proposes that, except as provided by the rule that makes the activity groupings made by Section 469 Entities determinative for equity owners of those Section 469 Entities, if a taxpayer is engaged in two or more trade or business activities and fails to report whether the activities have been grouped as a single activity or as separate activities, then each trade or business activity or rental activity will be treated as having been grouped as a separate activity for purposes of applying the passive activity rules (the “Default Grouping”).

By their nature, default rules have the potential for creating both winners and losers. However, in this situation, the Default Grouping will likely produce inequitable results.

For example, assume that a Covered Person engages in two trade or business activities that form an appropriate economic unit and the Covered Person relies on a grouping of the two activities to satisfy the standard for material participation under Regulation section 1.469-5(a)(1). Assume further that the Covered Person reports a net loss of $50 from the combined activity and this reporting is consistent with grouping the activities as a single activity, but the Covered Person fails to provide the disclosure that may be required under the rules proposed in Notice 2008-64. If the Default Grouping applies because the required disclosure is not provided, the default could result in tax treatment that is inconsistent with the Covered Person’s reporting and intended grouping.

Unfortunately, the Default Grouping may result in more than just a suspension of the $50 net loss from the combined activity. If the first activity of the Covered Person produced income of $60 and required 450 hours of participation and the second activity of the Covered Person produced a loss of $110 and required 90 hours of participation, our Covered Person will actually be required to suspend the $110 loss as a result of Temporary Regulation section 1.469-2(f)(2).

While the Service has a clear interest in consistent reporting, it seems inevitable that the Default Grouping will interact with the existing framework of recharacterization rules to the taxpayers’ detriment.

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22 Reg. § 1.469-4(d)(5).

23 In effect, with the Default Grouping, the Service proposes to extend the default rule currently applicable to the rental real estate activities of certain real estate professionals to the trade or business activities of all taxpayers who are subject to the passive activity rules. See Reg. §1.469-9.
Because, as mentioned above, Notice 2008-64 indicates that the Service’s intent is to provide a reporting system for grouping of activities under section 469 to aid the Service and taxpayers in verifying a taxpayer’s historical grouping of activities without undue burden to taxpayers, we suggest that the Default Grouping should be no more than a rebuttable presumption that may be overcome by evidence of consistent treatment by the Covered Person.