Update on IRC 469 Passive Loss Rule: A New IRS Procedural Reporting Requirement Creates a Trap For The Unwary That Could Be Costly To Aircraft Owners

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Tax planning for business aircraft acquisitions and operations frequently requires an in-depth analysis and consideration of the Passive Loss Rules of IRC Section 469. These rules include, among other things, rules governing what separate activities may be grouped together and treated as a single activity for purposes of measuring gains and loses. Failure to take IRC Section 469 into account in planning an aircraft ownership and operations structure can be a very costly error, as improper planning may result in millions of dollars worth of depreciation and operating expense deductions being disallowed.

It is no longer enough, however, to utilize a tax-efficient aircraft ownership and operations structure in order to ensure that such depreciation and operating expense deductions will be allowed. The IRS recently issued Revenue Procedure 2010-13 ("Rev. Proc. 2010-13") implementing for the first time a requirement that taxpayers who group certain activities together for purposes of applying the Passive Loss Rules must affirmatively disclose such groupings on their income tax returns. To be sure, Rev. Proc. 2010-13 establishes only a procedural rule; the Rev. Proc. does not alter in any way the substantive rules governing what activities may or may not be grouped. Rev. Proc. 2010-13 does, however, provide rather severe consequences for failure to disclose such groupings in the manner required by the Rev. Proc. Consequently, anyone who relies, or plans to rely, on the existing Grouping Rules to avoid the disallowance of various depreciation and/or operating expense deductions under IRC Section 469 should familiarize himself or herself with the new disclosure rules, and determine whether disclosure is required based on his or her specific circumstances.

The Passive Loss Rules are very complicated. It would be difficult, however, for any taxpayer to determine whether the Rev. Proc. 2010-13 applies to his or her specific circumstances without at least a basic understanding of the Passive Loss Rules, including the associated Material Participation Rules and Grouping Rules. Consequently, in this article, we will first provide a brief overview of the Passive Loss Rules of IRC Section 469, including the associated Material Participation Rules and Grouping Rules. We will then provide an example of how the Passive Loss Rules and the Grouping Rules may impact an aircraft

ownership and operations structure. Finally, we will discuss the new disclosure requirements implemented by Rev. Proc. 2010-13 and the potential ramifications of failure to make the disclosures required by Rev. Proc. 2010-13.

Overview of Passive Loss Rules

The Passive Loss Rules provide that net losses from a taxpayer's passive activities may not be used to offset net income from the taxpayer's non-passive activities. The term "passive activity" includes (1) any activity in which the taxpayer does not materially participate, and (2) any rental activity regardless of whether the taxpayer materially participates in the activity.

A "rental activity" is any activity where payments are principally for the use of tangible property, unless the activity falls within one of the following six regulatory exceptions:

i. The average period of use by customers is seven days or less (e.g., a rent-a-car business).

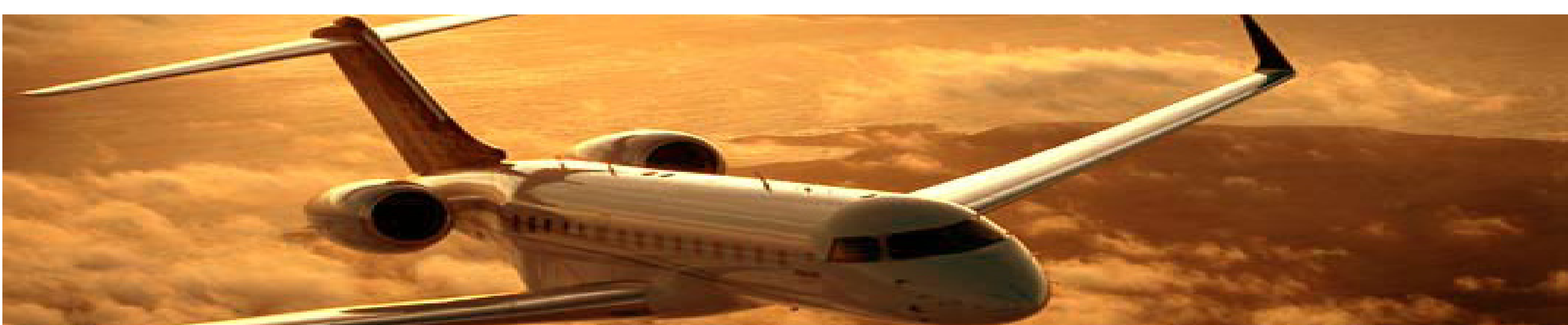
ii. The average period of use by customers is thirty days or less, <u>and</u> *significant* personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers (e.g., short-term equipment leases that include substantial services such as repair and maintenance of the leased equipment).

iii. *Extraordinary* personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers, <u>and</u> the use of the property is only incidental to the receipt of the services (e.g., an air charter business where an aircraft is provided with a pilot to operate the aircraft, and the use of the aircraft is only incidental to the provision of charter air transportation services).

iv. The rentals are only incidental to the holding of the property for investment purposes, or to the use of the property in another trade or business of the taxpayer (e.g., an aircraft owner/operator that uses an aircraft under Part 91 also allows a Part 135 charter operator to use the aircraft at times when the owner/operator is not using the aircraft). Such rental are only *incidental* if the gross rental income in a given year is less than 2% of the lesser of the property's unadjusted basis or fair market value.

v. The property is customarily made available for non-exclusive use by various customers during defined business hours (e.g., a golf course).

vi. The property is being provided to another pass-through entity or joint venture in which the taxpayer owns an interest (e.g., the owner of a commercial building provides the use of the building to another business in which the owner owns an interest). Note that there is some question as to whether this exception applies if rent is charged for the use of the property.



Material Participation Rules

Generally, any work done by an individual in connection with an activity in which the individual owns an interest is treated as participation in the activity by the individual. The extent of an individual's participation in an activity may be established by any reasonable means. Reasonable means include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. Creating and maintaining records of participation in the activity is critical.

For purposes of determining whether a taxpayer materially participates in each of two or more activities, it is not relevant that such activities may be operated by the same pass-through entity (or are considered to be operated by the same pass-through entity in a corporate structure wherein one legal entity is disregarded for tax purposes as an entity separate and apart from the other legal entity). Generally, taxpayers must satisfy the material participation requirements with respect to each separate activity regardless of whether or not they conducted through the same legal entity. Under certain circumstances, however, taxpayers may be permitted to group two or more activities together and treat them as a single activity for purposes of satisfying the material participation requirements. (See discussion of Grouping Rules below).

A taxpayer is treated as materially participating in an activity for any taxable year in which he (and/or his spouse) satisfies any one of the following seven tests:

i. The taxpayer participates in the activity for more than 500 hours.

ii. The taxpayer's participation in the activity constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity).

iii The taxpayer participates in the activity for more than 100 hours during the taxable year, and the taxpayer's participation in the activity is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity).

iv The activity is a significant participation activity, and the taxpayer's participation in all significant participation activities exceeds 500 hours (a significant participation activity is a trade or business in which an individual participates more than 100 hours, but does not otherwise qualify as a material participation activity under any of the other six tests).

v. The taxpayer materially participated in the activity during any five of the preceding ten taxable years.

vi. The activity is a personal service activity, and the taxpayer materially participated in the activity for any three prior taxable years (personal service activities are activities in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or any other

trade or business in which capital is not a material income-producing factor).

vii. The taxpayer participates in the activity for more than 100 hours during the taxable year, and based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis.

Time spent in certain types of activities may not be counted for purposes of satisfying the 100 hour or 500 hour requirements specified above. These include (1) work done in the capacity of an investor, unless the taxpayer is directly involved in the day to day management of the activity (e.g., studying and reviewing financial statements or reports, preparing studies or analyses of the activities finances or operations, and monitoring the activities finances or operations); (2) work not customarily done by an owner of such activity, (3) work performed for the principal purpose of avoiding the disallowance of losses under the passive loss rules, and (4) commuting time. Further, for purposes of the 100 hour test specified in item vii of the preceding paragraph, time spent in purely managerial activities may not be counted unless no other person is compensated for performing management services in connection with the activity, and no other person performs management services that exceed , by hours, the amount of such services performed by the taxpayer.

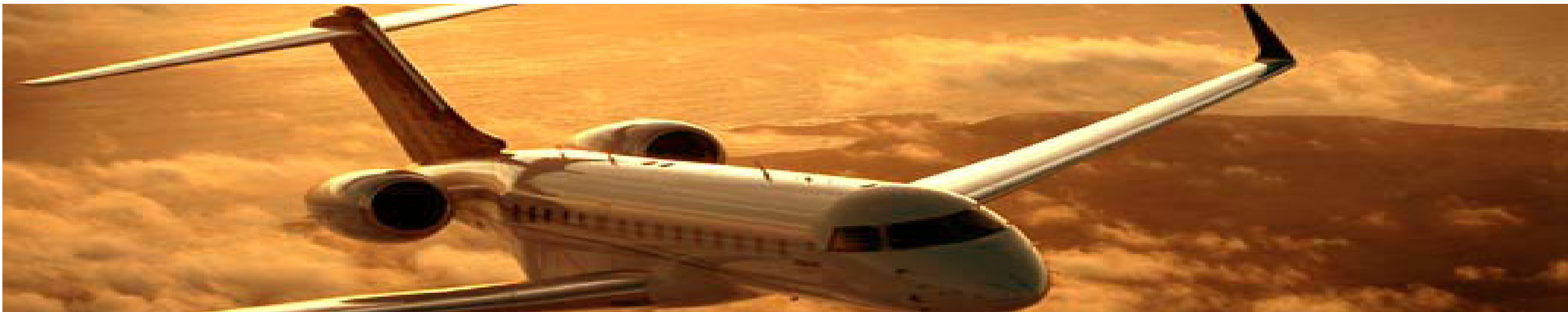
Grouping Rules

As previously indicated, for purposes of determining whether a taxpayer materially participates in each of two or more activities, it is not required that such activities be operated by the same pass-through entity. Generally, taxpayers must satisfy the material participation requirements with respect to each separate activity regardless of whether or not they conducted through the same legal entity. Under certain circumstances, however, two or more activities may be grouped together and considered a single activity for purposes of the passive loss rules of IRC Section 469.

Activities may only be grouped together if they constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Section 469. Whether activities constitute an appropriate economic unit is a matter of facts and circumstances, with greatest weight being placed on the following factors: (1) similarities and differences in types of trades or businesses; (2) the extent of common control; (3) the extent of common ownership; (4) geographical location; and (5) interdependence between/among the undertakings (for example, the extent to which the activities sell goods/services to one another).

Additionally, in order to group a rental activity together with a trade or business activity, either (1) one of the activities must be insubstantial in relations to the other, or (2) each owner of the trade or business activity must have the same proportionate ownership interest in the rental activity, and at least a portion of the rental activity must involve the rental of property for use in the trade or business activity.

Groupings can occur at both the entity level and at the individual partner/shareholder level. Where two or more activities are being conducted by a single partnership or “S” corporation, such entity may elect to group those activities together if the activities form an appropriate economic unit, or such entity may refrain



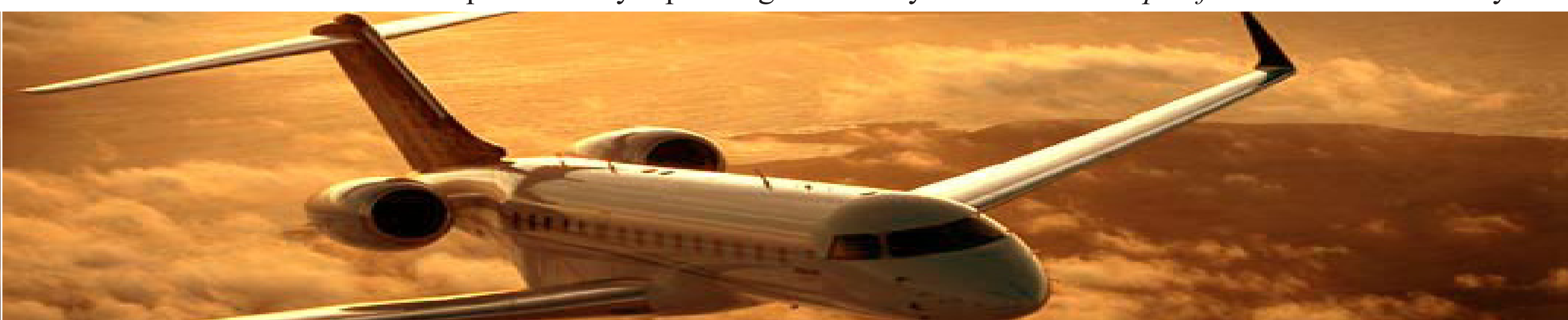
from doing so. Where such an entity does in fact group two or more activities together, such groupings are reflected in the entity's income tax return (Form 1065 for partnerships, and Form 1120S for S corporations), and in the Schedule K-1 provided to the partner/shareholder, in accordance with the instructions for those forms. At the individual level, an individual may elect to group together activities performed at the entity level that form an appropriate economic unit, even if the entity itself did not elect to group the activities together. Further, the individual may elect to group together activities performed by two or more separate partnerships and/or S corporations, as well as activities performed by the individual, when such activities form an appropriate economic unit. The individual may not, however, treat two or more activities as separate activities if such activities have already been grouped together at the entity level.

Treasury regulations provide that an analysis of the relationships of separate activities under these factors may produce more than one reasonable grouping, and that taxpayers may use any reasonable grouping method. However, if the taxpayer's groupings are unreasonable, the IRS may require another grouping method. Once separate activities are grouped together, they must remain so grouped absent a material change in facts and circumstances.

Application of Passive Loss Rules and Grouping Elections in Aircraft Ownership and Operating Structures

There are many ways in which the Passive Loss Rules could impact an aircraft ownership and operating structures. For example, suppose an individual ("Taxpayer") is the sole shareholder and CEO of an S corporation that conducts an active trade or business of some kind ("Operating Co."), and that Taxpayer materially participates in the business of Operating Co. Assume that Taxpayer (in his capacity as CEO of Operating Co.) has determined that having access to a business aircraft will enable Operating Co. to reach more customers and increase sales significantly, and that the costs of operating and maintaining such an aircraft would be an ordinary, necessary and reasonable expense for Operating Co. Assume further that Operating Corp's General Counsel has advised that for a variety of reasons (e.g., sales tax planning), (i) title to the aircraft should be held <u>not</u> by Operating Co., but rather by a separate, unrelated legal entity, such as an S corporation or limited liability company ("Aircraft Co."); (ii) that Taxpayer should be the sole shareholder or member of Aircraft Co.; (iii) that Aircraft Co. should lease the aircraft to Operating Co. on a dry lease basis (i.e., without pilot services); and (iv) that Operating Co. should employ a flight crew and be the sole operator of the aircraft. Finally, assume that Taxpayer acquires an aircraft and structures ownership and operations in accordance with the General Counsel's advice, and that the sole use to which the aircraft is put is to provide air transportation to Operating Co.'s officers and employees in support of the business of Operating Co.

This is a very common, albeit somewhat simplified, fact pattern. Under these facts, i*n the absence of an election to group the activities of Operating Co. and Aircraft Co.*, the leasing activity of Aircraft Co. likely would <u>not</u> satisfy the requirements of any of the six exceptions to a "rental activity" classification, as described above, and would therefore be considered a passive activity, regardless of whether Taxpayer materially participated in the activity or not. Consequently, any net losses produced by Aircraft Co. would not be available to offset net income produced by Operating Co. or any other *active* or *portfolio* income earned by



Taxpayer, but rather could only be used to offset net income from other *passive* activities owned by Taxpayer. This is problematic for two reasons. First, it is highly likely that Aircraft Co. will, in fact produce net losses rather than net profits, at least in the first several years of operations. This is because the tax depreciation deductions produced by business jet aircraft in the first several years of ownership typically exceed any operating profits produced by sole-purpose aircraft leasing companies. Second, in this authors experience, few individuals have sufficient passive income from other activities to absorb the net losses produced such sole-purpose aircraft leasing companies (notable exceptions include individuals with large scale, profitable investments in rental real estate).

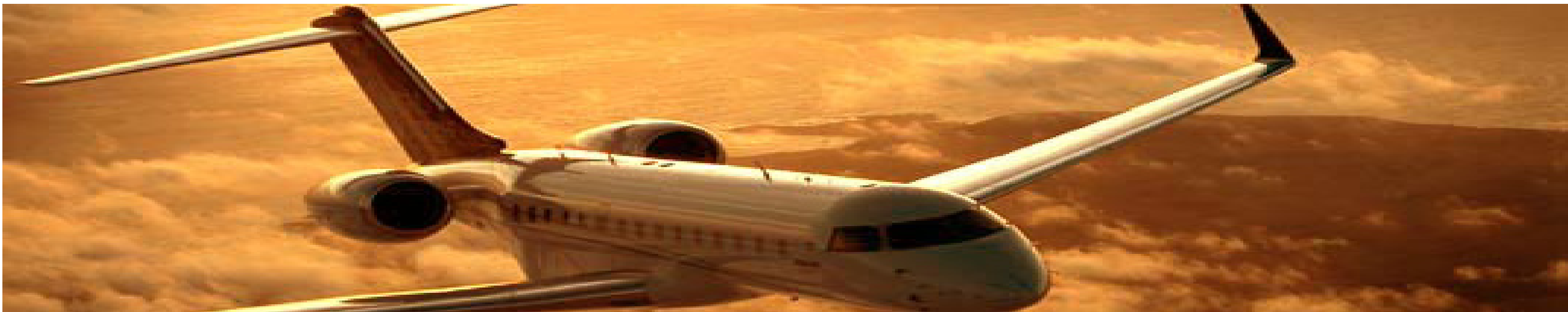
The adverse tax consequences produced by treating Aircraft Co. as a passive activity in the foregoing hypothetical may be avoided by making an election to group the activities of Operating Co. and Aircraft Co. together, and thereby treat them as a single activity. By grouping the activities together, and assuming the activities constitute an appropriate economic unit for the measurement of gain or loss, Individual should be able net any losses produced by the aircraft leasing activity of Aircraft Co. against any profits produced by the trade or business activity of Operating Co. (But see my article "Will the IRS Deny MACRS Depreciation for Your Aircraft Based on Your Business' Organizational Chart?" for a discussion on how a recent interpretation of IRC Section 280F announced by the IRS in TAM 200945037 may impact the ability of Aircraft Co. to claim depreciation deductions on these facts.)

IRS Revenue Procedure 2010-13

The New Grouping Statement Requirement

As mentioned above, groupings made by partnerships and S corporations are reflected in the entity's income tax return, and in the Schedule K-1 provided to the partner/shareholder, in accordance with the instructions for those forms. Until recently, however, individuals were under no obligation to disclose their own groupings to the IRS. This is no longer the case.

If in any tax year beginning on or after January 25, 2010, an individual desires to group together for the first time any two or more new or previously separate activities, or if the individual desires to add a new activity to a previously grouped activity, or if the individual desires or is required to regroup any previously grouped activities due to a material change in facts and circumstances that renders the previous grouping inappropriate, the individual must provide a statement identifying the activities being so grouped or regrouped with the individual's personal income tax return for the year in which such grouping or regrouping first occurs. There is no requirement, however, for an individual to provide a statement in order to group together two or more activities if such activities have already been grouped together at the entity level by a partnership or an S corporation, and such partnership or S corporation has already separately disclosed such groupings in the entity's own income tax return. There is also no requirement for an individual to file statement reporting groupings that were in effect prior to the effective date of Rev. Proc. 2010-13, unless and until the individual makes a change in his or her groupings.



The statement required under Rev. Proc. 2010-13 must identify the names, addresses, and employer identification numbers (if applicable), for the activities being grouped together. Further, the statement must contain a declaration that "t*he grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Section 469.*" Additionally, if the statement relates to a regrouping, the statement must also explain why the individual's original grouping was determined to be clearly inappropriate or the nature of the material change in facts and circumstances that made the original grouping clearly inappropriate.

Failure to Provide a Grouping Statement

In the context of a grouping or regrouping that first occurs during any tax year beginning on or after the January 25, 2010 effective date of Rev. Proc. 2010-13, a failure by an individual to provide the statement required under Rev. Proc. 2010-13 in the individual's income tax return for the year in which the grouping or regrouping first occurs results in the commencement of a race, of sorts. The race is to be the first to discover that the individual failed to provide the statement. According to Rev. Proc. 2010-13, if the individual discovers his or her failure, and then includes the statement in his or her next income tax return after discovering the failure, the individual will be deemed to have made the statement in a timely fashion, *provided* the individual's prior return(s) treated the income and deductions from the various activities in a manner consistent with the claimed groupings. However, if the IRS discovers the failure to provide the statement before the individual corrects such failure, the IRS will treat the activities as separate activities for purposes of applying the passive loss rules of IRC Section 469, *unless* the individual had *reasonable cause* for failing to provide the statement. It is not clear from the text of Rev. Proc. 2010-13 what would constitute *reasonable cause*.

Conclusion

Rev. Proc. 2010-13 is effective for all tax years *beginning on or after the January 25, 2010*. Since individuals typically are calendar year taxpayers, the first tax year *beginning on or after the January 25, 2010* for all calendar year taxpayers will begin on January 1, 2011 Consequently, for calendar year taxpayers, it shouldn't actually be *necessary* to include the statements required by Rev. Proc. 2010-13 with income tax returns until sometime in early 2012 when taxpayers begin preparing their 2011 income tax returns. And even then, the statements will only be *required* for groupings and regroupings that first occurred during 2011; groupings and regroupings that occurred prior to 2011 should *technically* be grandfathered, regardless of whether statements concerning such pre-existing groupings and regroupings are provided. Nevertheless, many conservative tax planners frequently recommend that taxpayers begin providing such statements immediately, rather than at the end of 2011, and that such statements address not only new groupings and regroupings, but also any pre-existing groupings and regroupings.

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