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subject: Aggregation of Activities under Section 465(c)(3)(B)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

A =

B =

M =

X =

Y =

Z =

Bank =

N1 =

N2 =

N3 =

N4 =

N5 =

N6 =

N7 =

N8 =

N9 =

N10 =

State1 =

State2 =

State3 =

Date1 =

Date2 =

Year1 =

Year2 =

ISSUE

May business activities conducted through a partnership and three separate S corporations be aggregated and treated as a single activity for purposes of the at-risk rules of § 465 of the Internal Revenue Code under the facts as described below?

FACTS

The facts submitted to us provide as follows:

On Date1, A, an individual, signed three separate promissory notes payable to B totaling $ N1 to purchase N2 percent (minority) ownership interests in three separate S corporations, X, Y, and Z (one note for each corporation). B is the majority owner in each of X, Y, and Z, and owns N3 percent of the ownership interests in X, N4 percent of the ownership interests in Y, and N5 of the ownership interests in Z. In Year2, A acquired a N2 percent ownership interest in M, an LLC treated as a partnership for federal income tax purposes. Although it is not clear from the facts as submitted, this N2 percent ownership interest in M was apparently given to A by B at least partially in exchange for A's personal guaranty of a line of credit of $ N6 between M and Bank executed by A on Date2. The other minority owners in M, X, Y, and Z are third parties unrelated to either A or B, and the ownership structure of M, X, Y, and Z are not identical (i.e., there is no overlap of minority owners among M, X, Y, and Z, besides A). The three promissory notes between A and B are each styled as "nonrecourse." Each promissory note provides that B's sole and exclusive remedy for any default on each respective note is to reclaim A's stock in the respective S corporation. A also executed Stock Pledge Agreements and Stock Restriction Agreements with respect to A's ownership interests in X, Y and Z, in favor of B. Under the Stock Pledge Agreements, A pledged A's stock in X, Y, and Z to B to secure the obligations of A under the three promissory notes. The Stock Restriction Agreements place certain other restrictions on the sale, assignment, gift, pledge, encumbrance or other disposition of A's shares of X, Y and Z, and include provisions for the disposition of the stock upon the death or the termination of employment of A.

M, X, Y, and Z are engaged in the business of Each entity operates a separate . The are conducted at different locations (in State1, State2, and State3) and sell from different manufacturers, and each has its own franchise agreement with the manufacturer that appears independent of the other franchises held through the other entities. M, X, Y, and Z each have their own lines of credit and (inventory financing) arrangements provided from their respective manufacturers. M, X, Y, and Z are accounted for using separate books and records, but the books and records for the four entities are maintained at a central location. M, X, Y, and Z utilize the same accounting method. It should further be noted that it appears that B is the majority owner of a number of other , besides those conducted through M, X, Y and Z, in which A has no ownership interest. A number of these other are located in places other than State1, State2, and State3, and likely have ownership structures that are different than M, X, Y, and Z.

There is a limited amount of employee sharing among M, X, Y, and Z. A is one of the small number of shared employees and, in addition, some employees of one will fill in for others at another when needed. For example, a manager working at one will fill in at another if the manager at that is unavailable. M, X, Y, and Z also share advertising, information technology, and accounting services. Otherwise, M, X, Y, and Z do not

routinely purchase goods and services from each other. The customer base of each of M, X, Y, and Z is the general public, so it is not possible to state the extent that may share the same customers (other than point out that these are located in different states and therefore it appears unlikely that the would share the same customers in most cases). M, X, Y, and Z do not carry on any other trades or businesses besides the , and M, X, Y, and Z do not hold any other assets besides the .

Each of M, X, Y, and Z employs one or more professional managers who have authority to exercise independent judgment in managing the day-to-day operations of their respective . However, all of these professional managers are overseen by A on a day-to-day basis. A spends over 500 hours a year working in of M, X, Y, and Z. In addition, A is responsible for identifying, interviewing, testing, recruiting, and hiring the operating managers and key personnel for the , and monitoring their teams' performance. A is also responsible for determining compensation and adjustments to drive commission-related performance . A regularly reviews operations of to maintain revenue growth and expense control for variable and fixed operations. A's time at is generally split 80 percent directing general management issues and 20 percent working with front line employees to spot check customer service and sales performance.

As stated above, in Year1, A executed a Guaranty of Payment in favor of Bank that personally guarantees a line of credit between M and Bank in the amount of $ N6. A's business assets as well as A's personal assets are subject to this guaranty. The line of credit is used for financing M's inventory and working capital. According to the facts submitted, this line of credit has been utilized by M, and the amount outstanding may vary over time, but generally most of the line of credit is currently outstanding. However, the funds advanced to M from the line of credit are used only in the business conducted through M, and none of the funds from this line of credit have been directly or indirectly distributed to or used in X, Y, or Z. This line of credit is also collateralized by M's inventory .

A filed an amended return for Year1 to claim losses from X, Y, and Z in the aggregate amount of $ N7. While not clear from the facts as submitted, it appears that these losses are treated as disallowed under § 465(a)(1) on A's Year1 return, and carried over to Year2 under § 465(a)(2). For Year2, A deducted losses of $ N8 from X, Y, and Z and a loss of $ N9 from M, and claimed a net operating loss deduction of $ N10 carried over from Year1 from X, Y, and Z. In addition, for Year2, A chose to group the business activities of M, X, Y, and Z together as a single trade or business activity for purposes of the passive activity loss rules under § 469. A argues that the activity aggregation rules of § 465(c)(3)(B) also allow him to treat the business activities of M, X, Y, and Z as a single activity for § 465 purposes. If this aggregation of business activities is permitted under § 465(c)(3)(B), A likely would be allowed to treat all of the losses from M, X, Y, and Z, as reported in Year2, as not subject to limitation under the

at-risk rules of § 465 as a result of A's personal guaranty of M's line of credit from Bank in Year2. A's personal guaranty would cause A to be at risk in the aggregated business activity in the amount of the outstanding balance of the line of credit (i.e., any remaining unpaid amount that had been previously advanced to M under the line of credit) at the close of each tax year, to the extent A remains personally liable for repayment of that amount under the guaranty at that time.

LAW

Section 465(a) provides that in the case of an individual, and a closely held C corporation, engaged in an activity to which § 465 applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of § 465(b)) for such activity at the close of the taxable year.

Section 465(b)(1) provides, generally, that for purposes of § 465, a taxpayer shall be considered at risk for an activity with respect to amounts including (A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and (B) amounts borrowed with respect to such activity (as determined under § 465(b)(2)).

Section 465(b)(2) provides that, for purposes of § 465, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he (A) is personally liable for the repayment of such amounts, or (B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the fair market value of the taxpayer's interest in such property).

Section 465(b)(3) provides, generally, that except to the extent provided in regulations, for purposes of § 465(b)(1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest.

Section 465(b)(4) provides that, notwithstanding any other provision of § 465, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

Section 465(c)(1) provides that § 465 applies to any taxpayer engaged in the activity of

(A) holding, producing, or distributing motion picture films or video tapes,
(B) farming (as defined in § 464(e)),
(C) leasing any § 1245 property (as defined in § 1245(a)(3)),
(D) exploring for, or exploiting, oil and gas resources, or
(E) exploring for, or exploiting, geothermal deposits (as defined in § 613(e)(2))

as a trade or business or for the production of income.

Section 465(c)(3)(A) provides that § 465 also applies to each activity (i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and (ii) which is not described in § 465(c)(1).

Section 465(c)(3)(B) provides that, except as provided in § 465(c)(3)(C), for purposes of § 465, activities described in § 465(c)(3)(A) which constitute a trade or business shall be treated as one activity if (i) the taxpayer actively participates in the management of such trade or business, or (ii) such trade or business is carried on by a partnership or an S corporation and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business.

Section 465(c)(3)(C) provides that the Secretary shall prescribe regulations under which activities described in § 465(c)(3)(A) shall be aggregated or treated as separate activities.

Section 1.465–8(a)(1) of the Income Tax Regulations provides that it applies to amounts borrowed for use in an activity described in § 465(c)(1) or (c)(3)(A). Amounts borrowed with respect to an activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor or is related to a person (other than the borrower) who has an interest in the activity other than that of a creditor. This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. For additional rules relating to the treatment of amounts borrowed from these persons, see § 1.465–20.

Section 1.465-20(a) provides that the following amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged—(1) amounts that do not increase the taxpayer's amount at risk because they are borrowed from a person who has an interest in the activity other than that of a creditor or from a person who is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor; and (2) amounts (whether or not borrowed) that are protected against loss.

ANALYSIS

The promissory notes signed by A used to purchase stock in X, Y, and Z appear to be sufficient to provide basis to A in X, Y, and Z for purposes of § 1366(d). However, given that the promissory notes represent amounts borrowed from a person, B, with an interest in the activities, A would not be at risk with respect to these borrowed amounts pursuant to § 465(b)(3), § 1.465-8(a)(1) and § 1.465-20(a)(1). A does not dispute this analysis. Instead, as stated above, A's position is that the aggregation rules of § 465(c)(3)(B) allow A to treat the conducted through M, X, Y, and Z as a single activity for § 465 purposes. Accordingly, if the business activities of M, X, Y,

and Z can be aggregated into a single activity for purposes of § 465, then all of the losses from M, X, Y, and Z would likely be allowable in Year2 as a result of A's personal guaranty of the line of credit of M from Bank in Year2 (even though the funds advanced under the line of credit is utilized solely by M). If A is not permitted to aggregate M, X, Y, and Z into a single activity under § 465(c)(3)(B), then the losses allocable to A from X, Y, and Z would be disallowed in Year2 under § 465(a)(1), since A would not be at risk with respect to the separate business activities conducted through X, Y, and Z.

The at-risk limitations of § 465 were added to the Code because of Congress' concern that taxpayers were deducting losses from tax-sheltering activities far in excess of their economic amount at risk in the activities. To prevent this abuse, § 465 limits the amount of any deduction for losses from a § 465 activity to the aggregate amount that the taxpayer is economically at risk in each such activity at the close of the taxable year. See S. Rep. No. 938, 94th Cong., 2d Sess. 47-48 (1976), 1976-3 (Vol. 3) C.B. 85-86. The thrust of § 465(a) is to allow a taxpayer to deduct losses only to the extent that the taxpayer bears a real economic risk of loss which is associated with those tax losses.

In order to determine whether A's position is correct, a number of questions regarding the proper interpretation of the statutory language under § 465(c)(3)(B) need to be addressed. Specifically, these questions are:

1) What is the proper definition of "activity" for purposes of § 465(c)(3)?
2) What is the proper test for determining whether a taxpayer actively participates in the management of activities that constitute a trade or business for purposes of § 465(c)(3)(B)?
3) Must multiple business activities constitute a single trade or business in order to be aggregated into a single activity under § 465(c)(3)(B)?
4) May activities that are conducted through separate entities that provide limited liability to their owners be aggregated into a single activity under § 465(c)(3)(B)?

Definition of Activity for Purposes of § 465(c)(3)

The statutory language of § 465(c)(3) provides no guidance as to the scope or meaning of the term "activity" (prior to the application of any aggregation rule).

With respect to the activities described in § 465(c)(1) and (2), § 465(c)(2)(A) provides that each such property as described will be treated as a separate activity, subject to rules similar to those contained in § 465(c)(3)(B) that allows aggregation of those activities if certain conditions are met. Accordingly, at least with respect to the activities described in § 465(c)(1) and (2), it seems clear that Congress intended for the definition of "activity" for § 465 purposes to be a relatively narrow and asset-specific concept.

The Staff of the Joint Committee on Taxation confirms this observation by stating that "[b]y contrast, the at-risk rules, to the extent they define 'activity,' address issues

different from those that are relevant with respect to passive losses. See § 465(c)(2). The at-risk rules define 'activity' in terms of narrow asset units, such as individual items of property, in light of the goal of such rules to establish a relationship between each such asset and financing attributable to it. In the passive loss context, unlike the at-risk context, financing is not the relevant issue." Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, 99th Cong., H.R. 3838, 99th Cong. at 246 fn. 40 (Jt. Comm. Print 1987) ("1986 Blue Book"). Accordingly, we believe it is reasonable to conclude that, similar to the definition of activity as applied to the activities in § 465(c)(1) and (2), the term "activity" for purposes of § 465(c)(3) (prior to the application of any aggregation rules contained or referenced in § 465(c)(3)) is intended to mean the smallest indivisible piece or parcel of property, business asset, or integrated business unit in which the taxpayer possesses an ownership interest.[1]

Accordingly, under the facts as presented in this case, we believe that, at most, the business activity of each entity (M, X, Y, and Z) comprises a separate activity for purposes of § 465(c)(3)(A) (prior to the application of any aggregation rules contained or referenced in § 465(c)(3)(B)).

Active Participation in Management of Activities that Constitute a Trade or Business

The statutory language of § 465(c)(3)(B) provides no definition or other specific guidance regarding the proper test for determining whether a taxpayer actively participates in the management of activities that constitute a trade or business. However, according to the legislative history for § 465(c)(3), Congress intended this inquiry to be a facts and circumstances based determination, stating that "[f]actors which tend to indicate active participation include participating in the decisions involving the operation or management of the trade or business, actually performing services for the trade or business, or hiring and discharging employees (as compared to only the person who is the manager of the trade or business). Factors which tend to indicate a lack of active participation include lack of involvement in management and operation of the trade or business, having authority only to discharge the manager of the trade or business, or having a manager of the trade or business who is an independent contractor rather than an employee." H.R. Rep. No. 95-1445, at 69 (1978) ("1978 Committee Report"); See also Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1978, H.R. 13511, 95th Cong., 29, 131 (Jt. Comm. Print 1979) ("1978 Blue Book").

[1] See also Proposed §§ 1.465-42(c)(1) and (2), 1.465-43(c), 1.465-44(c), and 1.465-45(c) which provide, in general, that a taxpayer's interest in each piece of property comprising an activity described in § 465(c)(1) will be treated as a separate activity of the taxpayer. In cases where the property is held through a partnership or S corporation, all of the property of the same type held through the partnership or S corporation will be treated as one activity of the taxpayer. There is no provision in the proposed regulations that allows the aggregation of activities across multiple partnerships or S corporations.

Section 465(c)(3) provides two separate tests with respect to active participation in the management of activities that constitute a trade or business. Section 465(c)(3)(B)(i) provides that activities that are described in § 465(c)(3)(A) that constitute a trade or business shall be treated as one activity if the taxpayer actively participates in the management of such trade or business. Section 465(c)(3)(B)(ii) otherwise provides that activities that are described in § 465(c)(3)(A) that constitute a trade or business shall be treated as one activity if such trade or business is carried on by a partnership or an S corporation and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business. In this case, A's position is that the activities of M, X, Y, and Z should be aggregated as a single activity under § 465(c)(3)(B) because they are all engaged in the same line of business ( ) and actively managed by A. A relies on both § 465(c)(3)(B)(i) and (ii) to advance this argument.

With respect to the test under § 465(c)(3)(B)(ii), A would have the burden of showing that the person (in this case B) who is allocated more than 65% of the losses from M, X, Y, and Z actively participates in the management of the business activities conducted through those entities. A has made no such showing, and we find it doubtful that A would be able to make such a factual showing given the large volume of duties and responsibilities that B delegated to A in order for A to manage those businesses on B's behalf. Accordingly, we conclude that A does not meet the requirements of § 465(c)(3)(B)(ii), because A has not shown (and probably cannot show) that B actively participates in the management of these business activities.

The application of § 465(c)(3)(B)(i) to the facts of this case is less clear. Section 465(c)(3)(B)(i) requires the taxpayer, A, to be the person who actively participates in the management of the trade or business. We believe A may be able to demonstrate active participation in the management of each of M, X, Y, and Z, given A's claimed duties and responsibilities in managing their day-to-day operations, if this were the only requirement of that provision (which it is not). Even in that regard, it is not clear to us how A can be actively engaged in the day-to-day management and operations of Y and Z, which are located in State2, and of M, which is located in State3, as A claims, when A lives and works in State1. However, in any event, it is not clear whether § 465(c)(3)(B)(i) was intended to apply to business activities conducted indirectly through partnerships or S corporations, rather than activities conducted directly by the taxpayer. This latter question will be explored in more detail below.

Component Activities Constituting a Trade or Business

The flush language in § 465(c)(3)(B) allows component activities which constitute a trade or business to be aggregated if the requirements in §§ 465(c)(2)(B) and 465(c)(3)(B) are satisfied. However, §§ 465(c)(2)(B) and 465(c)(3)(B) do not permit a taxpayer to use an amount at risk in one trade or business to support losses flowing from a wholly separate and distinct trade or business in which the taxpayer has no economic risk of loss, even if the taxpayer actively participates in the management of

both businesses. The aggregation provisions allow aggregation only within a SINGLE trade or business. There is no provision in § 465 that would permit aggregation of activities between two or more trades or businesses. Accordingly, activities that comprise or constitute two separate and distinct trades or businesses may not be aggregated into a single activity under § 465(c)(3)(B).

In this case, A would have the burden of showing that the business activities conducted through M, X, Y, and Z comprise a single trade or business for purposes of § 465(c)(3)(B). Under the facts as presented, M, X, Y, and Z each operate a separate and independent . The are conducted at different locations in three states located in different regions of the U.S., and sell from different manufacturers. Each has its own franchise agreement with the manufacturer independent of the other . Each has its own line of credit and (inventory financing) arrangement. There is a limited amount of employee sharing among M, X, Y, and Z. M, X, Y, and Z do share advertising, information technology, and accounting services, but otherwise do not routinely purchase goods and services from each other. M, X, Y, and Z are accounted for using separate books and records, even though the books and records are maintained at a central location.

Accordingly, in this case, we believe the facts and circumstances as presented weigh against treating the business activities conducted through M, X, Y, and Z as a single integrated trade or business for purposes of § 465(c)(3)(B).

Aggregation of Activities Conducted Through Separate Entities

In this case, A's position is that the that are conducted through three separate S corporations and an LLC treated as a partnership should be aggregated as a single activity for § 465 purposes because the activities conducted through these entities comprise a single trade or business. As stated above, A is relying on both § 465(c)(3)(B)(i) and (ii) to advance this argument. Therefore, the remaining question is whether either § 465(c)(3)(B)(i) or (ii) permits or requires a taxpayer to aggregate activities that are conducted through more than one partnership or S corporation. With respect to § 465(c)(3)(B)(ii), the statutory language by referring to "a partnership or an S corporation" limits the aggregation of activities to activities conducted through a single partnership or a single S corporation. We believe the legislative history for the Revenue Act of 1978 supports this interpretation. See 1978 Committee Report at 69; 1978 Blue Book at 131. As the 1978 Blue Book states, "with respect to these newly covered activities, those activities conducted by taxpayers other than partnerships and subchapter S corporations, and which together constitute a trade or business shall be treated as one activity if the taxpayer actively participates in the management of the trade or business; the same treatment would apply to those cases where the trade or business is carried on by a partnership or subchapter S corporation and 65 percent or more of the losses from the taxable year is allocable to persons who actively participate in the management of the trade or business." 1978 Blue Book at

131. We believe this legislative history for the Revenue Act of 1978 also supports the proposition that § 465(c)(3)(B)(i) was only intended to apply to business activities conducted directly by taxpayers (other than through partnerships or S corporations).

It should also be noted that, while not as explicit as the 1978 Blue Book, the 1978 Committee Report states that "[e]xcept for the [five] activities to which the specific at risk rule applies, neither of the at risk rules applies to direct investments (i.e., investments made directly, not through partnerships). Essentially, the committee believes that the lack of any application of the at risk principles to direct investments constitutes a major gap in the tax law in dealing with tax shelter abuses. Thus, the bill provides a revised at risk rule which would apply to investments (direct or indirect) in all activities except real estate. Examples of tax shelter investment activities to which the revised at risk rules would apply would include the direct sale to individuals of master phonograph records, lithographic plates, books, coal mining, and research and development." 1978 Committee Report at 68. We believe this provision in the Committee Report supports a reading that § 465(c)(3)(B)(i) was intended to apply to business activities directly held by the taxpayer (not held through a partnership or S corporation), whereas § 465(c)(3)(B)(ii) applies to any other business activities held through partnerships and S corporations.

When Congress expanded the scope of § 465 in 1986 to include real estate activities, the legislative history included a comment stating that "[t]he present law at-risk aggregation rules (§ 465(c)(3)(B)) generally apply to the activity of holding real property. Under these rules, it is intended that if a taxpayer actively participates in the management of several partnerships each engaged in the real estate business, the real estate activities of the various partnerships may be aggregated and treated as one activity with respect to that partner for purposes of the at-risk rules." S. Rep. No. 313, 99th Cong., 2d Sess. 750 (1985), 1986-3 (Vol. 3) C.B. 750; H.R. Rep. No. 426, 99th Cong., 1st Sess. 295 (1985), 1986-3 (Vol. 2) 295. This statement appears contrary to the statement contained in the 1978 Blue Book discussed above. Nevertheless, we believe that this language was included in the legislative history of the Tax Reform Act of 1986 to suggest that special aggregation rules should be adopted specific to activities of holding real property conducted through partnerships, but that such special rules otherwise might not be generally applicable to other types of trade or business activities or other types of entities.[2] It should also be noted that Congress did not discuss the possibility of aggregating real estate activities conducted through multiple S corporations, only those conducted through several partnerships.

[2] In this context, it should be noted that, in 1986, Congress also enacted § 465(b)(6) to provide that, in the case of an activity of holding real property, a taxpayer shall be considered at risk with respect to the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity if the requirements therein are satisfied. This exception for qualified nonrecourse financing is only available to taxpayers engaged in the activity of holding real property. We believe this is further indication that Congress likely believed that special rules (including rules for aggregation) should apply with respect to real estate partnerships, that otherwise would not be available to other types of business activities, when it expanded the scope of § 465 to include real estate activities in 1986.

In addition, we note that the Tax Reform Act of 1986 was enacted prior to the proliferation of state limited liability company (LLC) statutes and their formal treatment as partnerships or disregarded entities for federal tax purposes. In 1986, the only types of partnerships in existence were general partnerships (including common law partnerships) and limited partnerships. Partners in general partnerships almost always had unlimited liability with respect to partnership debt. Limited partners, of course, generally were accorded limited liability with respect to partnership debts, but were usually prohibited under state partnership laws from actively managing the businesses of the partnership. Therefore, in 1986, it was likely universally accepted that only general partners with unlimited liability could actively manage a partnership real estate activity. Since general partners would have unlimited liability with respect to partnership recourse liabilities, Congress likely saw little harm in allowing real property held through multiple partnerships to be aggregated by their general partners that actively managed each of the various properties. Congress therefore likely recognized that limited partners generally would be precluded from aggregating real estate activities held through multiple partnerships since they could not actively participate in the management of those activities.[3]

We understand that A has grouped the conducted through M, X, Y, and Z for purposes of § 469 and may contend that the activity grouping rules of § 1.469-4 are (or should be) applicable in determining whether multiple activities may be aggregated under § 465(c)(3)(B) for purposes of applying § 465. We reject this contention. As previously stated, Congress recognized that there was a significant difference in how § 465 and § 469 would operate. The at-risk rules were intended to address issues different from those that are relevant with respect to passive losses. The at-risk rules were intended to define 'activity' in terms of narrow asset units, such as individual items of property, in light of the goal of such rules to establish a relationship between each such asset and financing attributable to it. In the passive loss context, financing is not the relevant issue. See 1986 Blue Book, at 246 fn. 40. Moreover, the literal structure of the § 469 activity grouping rules is at odds with the statutory language of § 465(c)(3)(B). Under § 465(c)(3)(B), multiple activities may be aggregated into a single activity only in situations where the combined activities constitute a single trade or business. In contrast, the rules in § 1.469-4(c) contemplate and permit the grouping of multiple activities that may otherwise comprise two different and separate trades or businesses, as long as those activities form an appropriate economic unit for the measurement of gain or loss for purposes of § 469. In addition, § 1.469-4(c) permits the grouping of activities that are conducted through separate partnerships or S corporations, even though creditors of one entity usually cannot reach the assets of the other entities to satisfy legal claims. Section 469 allows such groupings because the

[3] See generally 1986 Blue Book, at 214, discussing limited partnerships and tax shelter activity: "[a]dditional considerations were viewed as relevant with regard to limited partnerships. In order to maintain limited liability status, a limited partner generally is precluded from materially participating in the business activity of the partnership; in virtually all respects, a limited partner more closely resembles a shareholder in a C corporation than an active business entrepreneur."

passive activity loss rules generally are not concerned about financing arrangements that protect taxpayers against loss. Unlike § 469, the at risk rules are primarily concerned about financing arrangements that protect taxpayers against loss, and conducting activities through multiple entities that limit the liability of their owners would be one such arrangement. Accordingly, we believe that the §1.469-4 grouping rules are irreconcilable with the statutory language contained in § 465(c)(3)(B) and with the underlying purpose of at risk rules under § 465, and therefore those activity grouping rules have no application for purposes of § 465.

Nevertheless, while we believe that the statutory language and legislative history for § 465(c)(3)(B) support disallowing aggregation of activities across multiple entities as explained above, we recognize that there has been a lack of regulatory and other guidance under § 465, along with a significant lapse of time and substantial changes in the fundamental nature of how taxpayers conduct business that have occurred since the enactment of § 465(c)(3)(B). Therefore, even though we believe § 465(c)(3)(B)(i) and (ii) generally should be applied to prohibit aggregation of activities across multiple entities, we recognize that there may be compelling cases where the facts and circumstances clearly indicate that the activities conducted through separate entities do comprise a single integrated trade or business for § 465 purposes (such as situations where the multiple entities are owned and managed by the same persons that share the same lenders and creditors who may have legal claims against the assets of all of the entities and their owners). We nonetheless believe that such compelling situations would be rare.

While the conduct of the activities through separate legal entities might not be a dispositive factor that, in itself, would prohibit aggregation of those activities under § 465(c)(3)(B)(i) and (ii), we believe that conducting activities through separate legal entities that limit the liability of their owners is a probative factor that should weigh heavily against aggregation. Accordingly, we believe that conducting activities through separate entities that limit the liability of their owners generally will be strong evidence indicating that the activities do not comprise a single trade or business for purposes of § 465(c)(3)(B), except when the facts and circumstances otherwise weigh heavily in favor of viewing the activities as a single integrated trade or business.

In this case, we believe the organization of the four into separate legal entities that limit the liability of their owners weighs heavily against treating the four conducted through M, X, Y, and Z as a single trade or business that would allow M, X, Y, and Z to be aggregated and treated as a single activity for purposes of § 465, and we see no countervailing factors in this case that would weigh heavily in favor of aggregation.

CONCLUSION

In this case, based on the facts presented, the conducted through M, X, Y, and Z operate independently from each other. There are few

interdependencies among them. Ownership among the entities is not identical. Each sells from different manufacturers and has separate franchise agreements and financing arrangements. Although the books and records of the are all located at a central location, each maintains separate books and records. The operate in different, non-contiguous states in different regions of the country. Employees generally work for a single , and employees are shared among the only in limited circumstances. The fact that the are conducted through separate entities that limit the liability of their owners, and the lenders and other creditors of the entities do not appear to have any claims against the assets of the conducted through other entities, further supports our conclusion that the conducted through M, X, Y, and Z do not comprise a single trade or business for purposes of § 465(c)(3)(B)(i) and (ii).

In addition, even though A may be able to show that A actively participates in the management of each of the for purposes of applying § 465(c)(3)(B)(i), we conclude that § 465(c)(3)(B)(i) does not allow aggregation of the business activities of M, X, Y, and Z because A does not conduct directly, but rather each is conducted through either a separate partnership or S corporation, and there are no other facts present that would weigh heavily in favor of viewing the separate as a single integrated trade or business.

Finally, A would have the burden of showing that B actively participates in the management of each of the conducted through M, X, Y, and Z, for purposes of applying § 465(c)(3)(B)(ii). Given that A has made no such showing, and given that we find it doubtful that A would be able to make such a factual showing for the reasons stated above, this would be another reason why § 465(c)(3)(B)(ii) does not allow aggregation of the business activities of M, X, Y, and Z.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-5279 if you have any further questions.

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