Do You Own Multiple Businesses? Consider this Tax Advice for Passive Losses

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Any time one of your businesses experiences a loss, you want to be able to claim those losses on your tax return. Unfortunately, the passive loss rules can stand in the way of these deductions, unless you plan ahead. In case you don't already know the passive loss rules, here's a breakdown of the requirements for deducting passive losses:

1. You must participate materially in the business that has losses in order to deduct those losses (or if you group the business with another, you must actually participate in the group); or
2. If you do not participate materially in the business, you must have other sources of passive income that you can deduct the losses against.

Grouping to Claim Passive Losses

Here's a likely scenario. A medical doctor owns a medical practice, and she would like to open a physical therapy business, but she does not plan to actually work at the new business. Someone else will handle management of this business, and employees will provide the services. The doctor understands that the business will likely lose money for the first couple of years.

However, the doctor does not have any other source of passive income; her only other business is the medical practice in which she actively participates. Therefore, she has to figure out some other way to avoid passive loss rules and claim her deductions. Aside from deducting the losses from other passive income, she could also wait to deduct the losses in total when she gets rid of her entire interest in this passive business.[1] But, she doesn't want to do that—she wants the deductions now because she doesn't plan on selling this business for quite some time.

As you can see from the above points, one option for getting around passive loss rules is to form a group from the multiple businesses you own. So, in order to deduct those losses, she groups her new physical therapy business with her medical practice. "Wait a minute," you may say. Even if she groups these two businesses together, doesn't the physical therapy business still have only passive income?

It turns out that in order to meet the material participation requirements, you *can* group your business together to form suitable economic units.[2] That means the businesses and business activities within the grouping must make sense together based on these factors (quoted from IRS Publication 925):[3]

1. The similarities and differences in the types of trades or businesses,
2. The extent of common control,
3. The extent of common ownership,
4. The geographical location, and
5. The interdependencies between or among activities.

Note that each business may conduct multiple sets of activities, and any entity structure may group its businesses or activities into one.[4] Even if you are the sole owner of three business that conduct four separate business activities, you can group all of these into one. Your material participation in the grouping then allows passive loss deductions for any of the business activities.

If you want to take advantage of such a common ownership grouping, you'll need to make the election on your tax return and attach a disclosure statement.[5] Additionally, you'll need to attach a statement with your tax return for any year that you add another activity to an existing group or regroup a grouping that was inappropriate. If you group inappropriately and don't follow the requirements, you could end up losing your deductions because the activities will be treated separately.

Your disclosure statements should include the names, addresses, and employer identification numbers for each of the businesses being grouped together. Once you've made the election to group, you're good to go with claiming deductions on an activity's passive losses, so long as you meet the material participation requirements for the group. What that typically means is you have to participate in the *combined* businesses for at least 500 hours per year. Going back to our doctor, if she works at the medical practice for 1,968 hours in the course of a year and never does any work at the physical therapy business, she has met the 500-hour test for the entire group.

Not everyone has two business interests that make sense together as an economic unit. If you, like the doctor, are considering opening a second business, but your second business operates in a completely different way from the first, you may not be able to take advantage of grouping. When that's the case, you should ask yourself, “Is it even worth it to start a business I cannot deduct losses for?” Remember, your tax deductions can make a big difference in your yearly profit.

Basically, you want to make sure the plans you make for your business ventures are the best choices for your bottom-line. Grouping elections are easy to make for the single-owner business, and the rules apply to real estate rentals, as well. So, if you have taxable income you'd like to offset, grouping may be a solution for your business.

1. IRC Section 469 ^
2. Reg. Sections 1.469-4(a); 1.469-5T(a)(1) ^
3. Reg. Section 1.469-4(c)(2). ^
4. Passive Activity Loss Audit Technique Guide (ATG), Training 3149-115 (02-2005), Catalog Number 83479V, p. 4-2. ^
5. Rev. Proc. 2010-13 ^