

# **Getting Ready to Defend the Material Participation IRS Examination**

by Lacey E. Strachan

Reprinted from *Tax Notes*, December 10, 2018, p. 1349

## Getting Ready to Defend the Material Participation IRS Examination

by Lacey E. Strachan



Lacey E. Strachan

Lacey E. Strachan is a principal at Hochman Salkin Toscher Perez PC, where she focuses on criminal and civil tax litigation.

In this article, Strachan discusses how taxpayers can defend a claim of material participation during an IRS examination.

Although taxpayers are allowed deductions for some business and investment expenses under sections 162 and 212, section 469 generally prohibits an individual taxpayer from deducting any passive activity loss for the tax year in which the loss is sustained, suspending the loss until a subsequent tax year.<sup>1</sup> A passive activity is defined generally as (1) any activity involving the conduct of a trade or business in which the taxpayer doesn't materially participate and (2) any rental activity, regardless of the extent the taxpayer participates in the rental activity.<sup>2</sup>

A taxpayer is treated as materially participating in an activity only if the taxpayer's involvement in the operations of the activity is regular, continuous, and substantial.<sup>3</sup> Generally, any work done by an individual regarding an activity in which he owns an interest when the work is done is treated as participation of the individual in the activity, except for work done by

the individual in his capacity as an investor (such as studying and reviewing financial statements), unless the individual is involved in the activity's day-to-day management or operations.<sup>4</sup> The IRS promulgated seven regulatory tests for determining whether a taxpayer materially participates in an activity:

1. the individual participates in the activity for more than 500 hours during the tax year;
2. the individual's participation in the activity for the tax year constitutes substantially all of the participation in that activity of all individuals (including individuals who aren't owners of interests in the activity) for that year;
3. the individual participates in the activity for more than 100 hours during the tax year, and the individual's participation in the activity for the tax year isn't less than the participation in the activity of any other individual (including individuals who aren't owners of interests in the activity) for the tax year;
4. the activity is a significant participation activity (a trade or business activity in which the individual participates for more than 100 hours during the tax year), and the individual's aggregate participation in all significant participation activities during that year exceeds 500 hours;
5. the individual materially participated in the activity for any five tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year;

<sup>1</sup>Section 469(a), (b).

<sup>2</sup>Section 469(c)(1), (2), and (4).

<sup>3</sup>Section 469(h)(1).

<sup>4</sup>See reg. section 1.469-5T(f)(1), (2).

6. the activity is a personal service activity, and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year; or
7. the individual participates in the activity for more than 100 hours during the tax year, and based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during that year.<sup>5</sup>

Questions on the IRC's material participation rules for losses frequently arise regarding real estate businesses, for which losses are common because of depreciation deductions and deductions for other costs incurred by the owner. There's an exception to the rule that rental losses are per se passive if the individual is a real estate professional within the meaning of section 469(c)(7), defined as a taxpayer who (1) spends more than 750 hours in the tax year working in real property trades or businesses in which he materially participates and (2) performs more than half his personal services during the tax year for real property trades or businesses.<sup>6</sup>

A real property trade or business is defined to include "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."<sup>7</sup> However, even if a taxpayer qualifies as a real estate professional within the meaning of section 469(c)(7), that doesn't mean the taxpayer's losses from real estate rental activities will automatically become deductible — the taxpayer must then prove that she materially participated in the rental activity by applying one of the material participation tests.<sup>8</sup>

Whether trying to satisfy the 750-hour real estate professional test, the 500-hour material participation test, or one of the other material participation tests, the taxpayer has the burden of

proving the amount and nature of his participation in the activity in a fact-intensive inquiry. Taxpayers who may have a loss from an activity would be well advised to maintain a contemporaneous time log documenting their daily participation, corroborated by other evidence such as calendar entries, receipts, or bills. But what do you do if your client hasn't been the perfect section 469 taxpayer and is facing an audit?

In those cases, the taxpayer should reconstruct her hours for the tax year under audit. The regulations don't require a contemporaneous time log to prove material participation. The extent of an individual's participation in an activity may be established by "any reasonable means," including (but not limited to) the identification of services performed over a period and the approximate number of hours spent performing those services during that period, based on appointment books, calendars, or narrative summaries.<sup>9</sup> Although this standard affords taxpayers significant latitude in proving their participation in an activity, cases have drawn the line at a post-event "ballpark guesstimate."<sup>10</sup>

There are numerous strategies for reconstructing a taxpayer's participation during a tax year without relying on such an estimate. Although in some cases a taxpayer's testimony regarding the specific work performed for an activity and the amount of time spent on each task may be sufficient to establish the amount of the taxpayer's participation in the activity, courts will generally look for corroborating evidence of a taxpayer's estimate of time.<sup>11</sup>

In its recent decision in *Birdsong*,<sup>12</sup> the Tax Court found that a taxpayer was a real estate professional and materially participated in her rental activity based on spreadsheets she prepared detailing her rental management activities regarding two rental properties she had

<sup>5</sup> Reg. section 1.469-5T(a)(1)-(7), (b)(2)(iii), and (c).

<sup>6</sup> Section 469(c)(7)(B).

<sup>7</sup> Section 469(c)(7)(C).

<sup>8</sup> The material participation tests are subject to limitations when applied to rental activities. Moreover, when applying the material participation tests, each rental must be treated as a separate activity unless the taxpayer has made an election to group her rental properties as a single activity.

<sup>9</sup> Reg. section 1.469-5T(f)(4).

<sup>10</sup> *Bailey v. Commissioner*, T.C. Memo. 2001-296; *Goshorn v. Commissioner*, T.C. Memo. 1993-578.

<sup>11</sup> See *Hatcher v. Commissioner*, 726 F. App'x 207, 214-216 (5th Cir. 2018) (affirming a Tax Court holding that the taxpayer proved up to 450 hours of participation through his credible testimony despite the taxpayer's lack of documentation; however, the taxpayer couldn't reliably quantify any additional hours based on the record).

<sup>12</sup> *Birdsong v. Commissioner*, T.C. Memo. 2018-148.

elected to group for purposes of section 469. The spreadsheets included time the taxpayer had reconstructed using her calendar and receipts from the relevant period.<sup>13</sup> Concluding that the petitioners' narrative summary and thorough time logs were convincing, the Tax Court reasoned that the "petitioners testified credibly and in detail about petitioner wife's active and extensive management of their rental properties" and that the spreadsheets were "detailed" and "reflected petitioner wife's rental management activities."<sup>14</sup>

A taxpayer's successful reconstruction of time was also demonstrated in the Tax Court's decision in *Tolin*.<sup>15</sup> In that case, the petitioner introduced at trial a narrative summary in which he described the work he performed for the operation of a thoroughbred horse breeding and racing activity and estimated the time he spent performing that work for each of the years at issue.

The taxpayer reconstructed his time with his attorney's assistance, using telephone records, credit card invoices, and other contemporaneous materials. For each year, the taxpayer identified the following work performed for his thoroughbred activity: preparing and distributing promotional materials; telephone conversations with his associates, advisers, and potential customers; business trips to Louisiana; registering his horses for state and national awards; reviewing and placing mortality insurance on a stallion he owned; reviewing and paying bills; recordkeeping; and continuing education.<sup>16</sup>

The taxpayer then estimated the total number of hours spent on each activity. For example, he estimated that he spent 311 hours on telephone calls. Rejecting the IRS's argument that the estimates were unreliable because they were prepared solely for litigation and were based in large part on the petitioner's memory, the court was satisfied with the petitioner's estimate based on his testimony regarding the purpose and nature of the calls he made in his business, testimony by third-party witnesses who were on

the receiving end of his phone calls, and available cell and landline phone records.<sup>17</sup>

As these cases demonstrate, when having to reconstruct time for a prior year, detail and specificity are key. A taxpayer should describe all the work she performed for the activity during the year in question and use a reasonable method of estimating the number of hours spent on each task during the tax year. To help determine and corroborate her estimates, the taxpayer should consider any records available from that period that could be used to support what she was doing during that time. For example, calendar entries, emails, call records, credit card statements, phone records, contracts, receipts, and mileage records may all help provide contemporaneous documentation to support a taxpayer's narrative summary of her participation in a given activity. While a time-intensive endeavor, that effort will put your client in the best position to defend her claim of material participation. ■

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at \*7.

<sup>15</sup> *Tolin v. Commissioner*, T.C. Memo. 2014-65.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at \*35-\*41.