

Determining Material Participation— Passive Versus Nonpassive

By Wendy Shireman, CPA

“People need to be reminded more often than they need to be instructed.”— Samuel Johnson

While there haven't been any recent changes in the material participation laws, they are important to apply correctly and therefore worthy of a refresher. The status as a passive or nonpassive activity will determine if a loss from the activity is deductible, or if it should be suspended. The classification is also important because of a passive activity's subjectivity to the Net Investment Income Tax (NIIT) of an additional 3.8 percent on top of the ordinary rates. Because this classification issue is determined on an annual basis, it's important, and more efficient, if practitioners know the rules well. Most research software providers have put together useful flow charts to help walk practitioners through the requirements of this law. Firm best practices would be to discuss these tests with taxpayers who own a business, and document their responses. Firms could also consider including participation questions with their year-end organizers, if they use them. Once you determine the classification for the current year, be sure to double check the codes in your tax software, as those will likely roll forward with the prior year classification as a default.

If taxpayers can answer “yes” to *any* of the following questions, they are considered a material participant in the activity for the tax year.

1. Did the taxpayer participate more than 500 hours in the activity?
2. Did the taxpayer do substantially all the work in the activity?
3. Did the taxpayer participate more than 100 hours in the activity and no other owner or employee participated more hours than the taxpayer?
4. Did the taxpayer participate more than 100 hours, but less than 500 hours, in two or more activities resulting in total participation in all activities of more than 500 hours?
5. Did the taxpayer materially participate (did they pass any of the above tests) in the activity for any five of the past 10 years?
6. If this is a personal service activity, did the taxpayer participate for any of the past three years?
7. Did the taxpayer have any other facts or circumstances that would indicate material participation?

Let's address the term “participate” as the law defines qualifying and non-qualifying services performed by the taxpayer. The first hurdle for qualifying time is that the

taxpayers must own an interest in the activity in order for their work to be treated as participation. Menial

tasks as well as supervision and management duties all qualify. Examples of non-qualifying duties include those related to the taxpayer's role as an investor. If the taxpayer spends time searching for a buyer for the business, that time would not apply for passing the participation test. For taxpayers' services to qualify as participation, they must be directly involved in the day-to-day operations and management of the activity.

There are some special considerations and exceptions to be aware of when applying these tests. For one, limited partners are generally not considered to participate in the activity where they hold a limited interest unless they pass the first, fifth, or sixth tests mentioned above. The other tests are not available to limited partners. Another interesting twist on the application of the tests is that if a taxpayer's spouse materially participates in an activity, the taxpayer is also considered to participate. This is the case even if the spouse doesn't own an interest in the activity or file a joint return with the taxpayer. As with all deductions, substantiation of time spent working in the activity is necessary to validate the classification. Taxpayers can substantiate participation using any reasonable method, but a good suggestion is using a planning calendar where they document actual time spent and tasks performed for the activity for the day.

If a taxpayer is an owner of several activities, he or she can elect under Code Section 469 to group the activities together into one combined activity. Grouping often makes it easier to pass the material participation standards. Although the Regs provide for the use of any reasonable method for grouping, they suggest some common factors. These factors include similarities in types of businesses, extent of common control or ownership, and geographical location. Be aware of the potential drawbacks when grouping activities with suspended losses. Selling pieces of the combined activity will generally not be sufficient to allow suspended passive losses to be freed up.

Don't simply let your software default to last year's classification. Give your clients a call to discuss how they spend their time. Who knows? You might find another way you can serve them, thereby adding to your perceived value, and generating more revenue for your firm.

Wendy Shireman is a principal with Brown Smith Wallace in St. Louis and serves on the MSCPA Taxation Committee. She can be reached at wshireman@bswllc.com.