# Material Participation as Significant Participation Activity

## *Tax Court Ruling Highlights Importance of Grouping Election*

*By Robert S. Barnett*

A recent case serves as a convenient reminder for 2020 tax return elections. In *Gurpreet S. Padda, et al. v. Comm'r* (TCM 2020-154), a physician met the test for significant participation activities with respect to several restaurants and a brewery in which he was a substantial owner. The entities were established as limited liability companies; although the physician operated several medical facilities and clinics, he was able to prove that he devoted substantial time and efforts to the restaurants and brewery. The restaurants and brewery incurred substantial losses that offset income from the medical practice. The central issue relevant to this article was whether Padda met the material participation requirement to avoid the passive activity loss limitation.

### Passive Activities

IRC section 469(c) defines passive activities as including any trade or business in which the taxpayer does not materially participate. The Tax Court discussed that material participation requires the performance of regular, continuous, and substantial services in the activity—which can be established by satisfying any one of seven tests enumerated in the Treasury Regulations. One of these tests for material participation involves significant participation activities. Treasury Regulations section 1.469-5T(c) describes the requirements for significant participation activities, which are limited to trades or businesses in which the taxpayer meets a significant participation test. This test is met if the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours and the individual is able to show participation of over 100 hours during the year in each activity. In *Padda*, the five restaurants and the brewery constituted trade or business activities; the taxpayer was able to prove that the requisite hours were met. As discussed below, the taxpayer was thereby able to achieve material participation and utilize the business losses to offset his medical practice income.

The Tax Court also discussed the grouping rules for passive activities. In this upcoming tax filing season, it will be extremely important for taxpayers and their advisors to consider both their grouping and aggregation elections with respect to business and rental activities. Grouping activities may enable taxpayers to meet the material participation requirements. Although a detailed discussion of the grouping rules is beyond the scope of this article, Treasury Regulations section 1.469-4 permits grouping of activities if they constitute an appropriate economic unit. For example, if a taxpayer has five business activities and spends 155 hours in each activity, the over 500–hour test will be met if the taxpayer is able to group the activities. In this example, if the activities are rental real estate activities, an aggregation election should also be considered if the taxpayer can meet the requirements for qualification under section 469(c)(7).

With respect to grouping, Treasury Regulations section 1.469-4 allows this approach if the activities constitute an appropriate economic unit for measurement of gain or loss based on the appropriate facts and circumstances. Proper grouping will allow potential benefits. First, gains and losses from the grouped activities may be combined; and second, the hours spent working on the combined activities are permitted to be aggregated in meeting the material participation test. Treasury Regulations section 1.469-4(c)(2) describes some of the relevant factors, including the extent of common control, location, and interdependencies among the activities. Revenue Procedure 2010-13 describes the grouping rules for trade or business activities, and Revenue Procedure 2011-34 applies to qualified real estate professionals. Both provide guidance for late elections. Grouping elections must be properly disclosed and are generally made by a written statement included with an original tax return. Income tax preparers should add this inquiry to their filing checklists.

## The Tax Court Decision

In *Padda*, the taxpayers did not elect to group the five restaurants and the brewery; therefore, the court counted the hours of each as a separate activity. Had the taxpayers properly grouped the business activities, perhaps they would have avoided a costly trial and had an easier method of proving material participation by including all participation in the grouped activity. Based on the facts described in the opinion, there appear to be sufficient factors to support a grouping election. Had Padda elected to group the activities, he may have avoided substantial uncertainty and a costly trial.

Padda presented testimony regarding the hours he spent on restaurant and brewery activities. He testified for an entire day at trial and explained in detail his involvement and working hours. Other witnesses also testified regarding his management activities. The taxpayer participated in every aspect of the restaurants and brewery in a very hands-on manner. He also provided onsite instruction at the various businesses. The court was impressed by his testimony, which helped to support the hours he spent on each activity during the year. To meet significant participation, the taxpayer was able to show that he spent more than 100 hours at each activity; because there were six activities, he could account for more than 600 hours. Therefore, he was able to show that he spent over 500 hours of work at the significant participation activities, and that the material participation requirement was met.

It is interesting to note that, in addition to the work performed at the businesses, the court accepted the business travel time spent by the taxpayer. Again, the testimony was found to be credible and accurately established that the trips were fact-finding trips, related to work at the restaurants and brewery, and were not for personal purposes. Detailed spreadsheets were provided documenting the travel and time spent at the various business locations. The court found that the time spent traveling was in addition to the time the taxpayer spent at each of the locations.

The IRS asserted negligence and substantial understatement penalties of 20% related to the deduction of the business losses and for other unreported income under IRC section 6662. This case highlights the fact that the IRS has been extremely aggressive in imposing penalties, even where there are substantial factors in the taxpayer's favor. In this case, the taxpayer ultimately proved his material participation and prevailed with respect to the loss allowance; therefore, the business losses were allowed for the significant participation activities. If the taxpayer was not able to prevail, the IRS penalties would have likely been affirmed, despite the complex and substantial factors in the taxpayer's favor. The taxpayer would have had the burden to show reasonable cause and good faith; such burden would be difficult to meet if the taxpayer was unsuccessful in meeting the material participation test.

CPAs should be aware that penalty assertion frequently accompanies audits of taxpayer losses. Loss disallowance often occurs due to the following factors: insufficient basis, inability to properly document the business nature of the deduction, failing the at-risk rules, and failing to substantiate the material participation requirements of the passive activity rules. Income tax preparers should carefully review all appropriate elections and grouping opportunities, and should consider filling Form 8275 along with the required disclosure in order to avoid the imposition of penalties. The *Padda* decision presents another method for measuring and meeting the material participation requirement, and it includes a helpful discussion of the related considerations and proof required. ■

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