

Using Technology to Satisfy the Material Participation Requirement of IRC Sec. 469

Eddy J. Burks
Troy University

Stanley X. Lewis, Jr.
Troy University

Amanda N. Paul
Troy University

C. Lee Daniel
Troy University

ABSTRACT

In today's world numerous employees and self-employed persons work from home via electronic means. The research describes how, with proper planning and documentation, self-employed and part-owners (investors) can meet the "material participation" requirement thereby avoiding the passive loss rules with the use of technology. Internal Revenue Code Sec. 469 defines passive activity losses. The term passive activity means any activity which involves conduct of any trade or business and in which the taxpayer does not materially participate. A review of court cases where taxpayers were denied the "passive losses" usually hinged on lack of proper documentation. The courts used the phrase "post-event ballpark guesstimate" in trying to meet the material participation requirement. The research reports a review of the currently available software for capturing, saving, and storing your daily work routine.

Keywords: material participation, IRS Sec. 469, technology, passive activity

INTRODUCTION

For owners of profitable unincorporated businesses and flow-thru entities reporting income/gains is straight forward. When these entities generate losses determining whether the loss is currently deductible becomes complicated. One complication is the “passive loss” rules of Internal Revenue Code Sec. 469 which is the basis for this research. If an owner is a material participant the passive loss rules may be avoided and the losses may be currently deductible.

IRC Sec. 469(h)(1) provides that, generally, an individual shall be treated as materially participating in an activity only if he or she is involved in the operations of the activity on a basis that is regular, continuous, and substantial. The regulations identify seven situations in which an individual will be treated as materially participating in an activity:

- 1) The individual participates in the activity for more than 500 hours during such year;
- 2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
- 3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
- 4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
- 5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
- 6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
- 7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year. (Treasury Regulation Sec. 1.469-5T(a))

With these quantitative type rules, it seems logical that one would structure their work routine to be in compliance with the regulations. That may be the case at the time when an individual has a clear short-term memory and is willing to create well-documented files. Several years later in court, the memory has faded and files have been misplaced. The judges call undocumented recollections “post-event ballpark guesstimates” and disallow the deductions, even though this is contrary to Treasury Regulation Sec. 1.469-5T(f)(4). The regulations sec. 1.469-5T(f)(4) expressly provides that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days; most individuals do not customarily maintain such records. Accordingly, under the regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable

means, including, but not limited to, appointment books, calendars, and narrative summaries. (Treasury Regulation Sec. 1.469-5T (f)(4))

TAX CASES

Examinations by the Internal Revenue Service (Service) have resulted in several cases in which taxpayers have disagreed with the decisions of the Service. The consistent rulings in the U.S. Tax Court, U.S. Federal District Courts, and the U.S. Court of Appeals are to deny material participation without definitive documentation by the taxpayer. The courts have coined a term “post ballpark guesstimate” when records do not exist to substantiate the claim. A selection of relevant cases in which losses were denied is presented in Table 1.

In *Peter Ackerman and Joanne Leedom-Ackerman v. Commissioner, Mr. Ackerman* could not provide reliable evidence establishing the amount of time that he spent during each of the years 1998, 1999, and 2000 communicating with company officials on matters relating to the activity. Mr. Ackerman could not produce reliable evidence determining the number of days spent at the activity’s location during the years in question. In this case just a simple calendar with days marked would have sufficed. By the time this went to court electronic documentation and communications had been lost.

In *Loren A. Dean v. Internal Revenue Service*, plaintiff, a limited partner failed to prove that he materially participated in a brokerage company’s activities for at least 500 hours during the tax year. He was uncertain about the number of hours he worked and his brother’s testimony regarding his participation in the company’s activities provided merely an estimate. Dean alleged time spent on computer and telephone were enough to qualify. By the time audit was instigated electronic documentation and communications were lost.

Marilyn S. Scheiner v. Commissioner was a case involving a member of a condominium board. Scheiner was a professor that invested in a condominium hotel and was elected to the board. She could not provide evidence of her material participation regarding her own unit, specific time spent on her unit was co-mingled with board work. Needed more specific information pertaining to the character of work performed.

In *Douglas A. Schmuecker v. Commissioner* losses claimed by an individual who owned or co-owned race horses were disallowed because the owner kept no written records to adequately substantiate the time that he spent on the activity. Petitioner claimed time spent, 2 to 3 hours per day, doing Internet research on which horses to purchase. Petitioner also claimed time spent communicating with other people about prospective horses. Again, the computer searches were not documented. The details of telephone communications were could not be reconstructed.

The major reason for denying the plaintiffs’ claims was lack of documentation. There are a couple of reasons for this lack of documentation. The first is just “ignorance of the law”. As seen in the court cases the plaintiffs’ are engaged in part-time activities. At the time, they were not aware of the Sec. 469 requirements. The second is “due diligence”. As the work environment has changed with technology the use of pen and paper has decreased. If each plaintiff had taken the time to record on their calendar, date, time, who, and content of each phone call the evidence would be there later. For each session on a computer, date, time, and each website visited could be captured, however to do this manually each time is a burden. Therefore we have to adopt new technology to capture and store our daily routines. The next section will explore some of the newer tools that may be used for documentation.

MONITORING SOFTWARE

The technology industry has numerous products available for the investor's use in documenting usage of computer, internet, and cell phone. The investor should evaluate each and select the software that would fit the needs in the specific business environment. SpectorSoft Corporation offers products that include technology that can monitor specific employees as well as the entire company.(SpectorSoft) Another vendor, Parental Control Products, LLC, offers a low level software product that can be effectively used by startup companies and in SOHO (small office, home office) environments under the software name of PC Tattle Tale.(Parental Control) Both products are inexpensive, under one hundred dollars, and offer a comprehensive range of features which are discussed below.

Upon installation and activation of the software the best and main feature is working: automatic recording. Each keystroke and password is captured. Each website visited and screen shots are recorded. Then additionally online searches are recorded. Your emails, both sides sent and received, are recorded. So if Mr. Schmuecker, above plaintiff, had been using this software his computer searches on investigating which horses to purchase would have been documented. The practice of backing up your files and data is also pertinent here. The record of your usage needs to be kept secure until the statutes of limitation or audit process has expired. An automatic backup to a Cloud Storage site could be implemented. (Lewis) Other features include tracking your social network interactions, such as Facebook and MySpace.

For your PDAs there are similar programs but you have to save your information to a hard-drive. Data Doctor and Pro Data Doctor both offer inexpensive applications. The process of recording your cell phone history is more complicated. The SIM card generally has to be removed and inserted into a reader. This is a problem for Verizon users, Verizon supported cell phones in the U.S. do not have removable SIM cards. However, contacts and numbers called may still be logged. If a business wishes to add other features such as data recovery to documentation features then software such as Pro Data Doctor should be evaluated. (Pro Data Doctor Pvt. Ltd.

Using RIA's checkpoint a search with the key terms material participation, IRS Sec. 469, technology, and passive activity did not yield any cases in which technological documentation was used successfully by a taxpayer in defense of the material participation requirement of IRC Sec. 469. Additional searches adding software, computer data and computer program as key terms had the same results. The authors concluded that successful use of documentation never reached the courts. In those cases in which the court found in favor of the taxpayer, the description of the evidence did not indicate that it was computer generated. As technology advances, it is likely that this trend will change.

DEMONSTRATION CASE

Five friends formed a partnership named FISH. The partnership opened a chain of ten restaurants across the state of Maryland. Partner GM owns the majority, fifty-one percent, and operates the partnership as the general manager. PR, a limited partner, owns ten percent and lives in the state of Florida. The first year FISH reported a taxable loss of one million dollars. Since PR is the general manger, a material participant, he may deduct his share of the losses. How will PR report the losses? It will depend on whether the material participation requirement was satisfied. The following scenarios could occur:

	PR <u>Material Participant</u>	PR <u>Not a Material Participant</u>
Other taxable income	\$500,000	\$500,000
FISH loss - deductible	(100,000)	-0-
Taxable Income	\$400,000	\$500,000

When the partnership was formed PR asked to participate within the business. Since she had accounting experience she agreed to handle the payroll function. Each week she received the time sheets from the ten restaurants. In her home office in Florida she would spend at least ten hours a week processing the payroll. So during the year she accumulated more than five hundred hours to become a material participant. She also had installed Spectorsoft to document time spent on the computer. She did deduct and reduce her taxable income by one hundred thousand dollars, her share of the loss.

For most businesses there are numerous functions that can be performed from remote sites. So depending on the needs of the investors the Sec. 469 material participation requirement may be satisfied with proper planning and documentation.

CONCLUSIONS

The current business environment is one of numerous employees and self-employed persons working from home via electronic means. With proper planning and documentation, self-employed and part-owners (investors) can meet the “material participation” requirement avoiding the passive loss rules. The use of technology can aid the taxpayer in meeting the Internal Revenue Code Sec. 469 definition for documentation of activities related to passive activity losses. The review of court cases indicates that proper documentation is critical for business owners and employees. The research suggests that software is available and effective to use for this documentation requirement.

REFERENCES

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APPENDIX

TABLE 1- TAX CASES

<p>Peter Ackerman and Joanne Leedom-Ackerman v. Commissioner, U.S. Tax Court, CCH Dec. 57,790(M), T.C. Memo. 2009-80, 97 T.C.M. 1392,(Apr.15, 2009) (ballpark guesstimate)</p> <p>Mr. Ackerman could not provide reliable evidence establishing the amount of time that he spent during each of the years 1998 and 2000 communicating with company officials on matters relating to the activity. Mr. Ackerman could not produce reliable evidence determining the number of days spent at the activity’s location during the years in question.</p>
<p>Standard Federal Income Tax Reporter, Loren A. Dean, Plaintiff-Appellant v. Internal Revenue Service, Department of Treasury, Defendant-Appellee., U.S. Court of Appeals, Ninth Circuit, 2009-1 U.S.T.C. ¶50,185, (Sept. 2, 2008).(ballpark guesstimate)</p> <p>Plaintiff, a limited partner failed to prove that he materially participated in a brokerage company’s activities for at least 500 hours during the tax year. He was uncertain about the number of hours he worked and his brother’s testimony regarding his participation in the company’s activities provided merely an estimate.</p>
<p>Barry H. and Marilyn S. Scheiner v. Commissioner, U.S. Tax Court, CCH Dec. 51,700(M), T.C. Memo. 51700(M), 72 T.C.M. 1532, T.C. Memo. 1996-554, (Dec. 23, 1996) (ballpark guesstimate)</p> <p>A professor who invested in a condominium hotel and was a board member did not establish material participation relating to the rental activities. There was no reliable evidence regarding the petitioner’s activities as a board member and the time specifically related to her unit.</p>

Sidney C. Shaw v. Commissioner, U.S. Tax Court, CCH Dec. 54,640(M), T.C. Memo. 54,640(M), 83 T.C.M. 1194, T.C. Memo. 2002-35, (Feb. 6, 2002) (ballpark guesstimate)

The taxpayer failed to prove that his real estate activities were non-passive because he qualified as a real estate professional. Although he claimed that he devoted more than 750 hours he failed to record the number of hours spent in any activity and his attempt to reconstruct his hours through his testimony regarding his participation was unpersuasive.

Francis J. and Andrea P. Bogus v. Commissioner., U.S. Tax Court, T.C. Summary Opinion 2009-160, (Oct. 19, 2009) (ballpark guesstimate)

Passive loss rules precluded a married couple from deducting losses incurred from their dog racing activity. Husband was regularly involved in the activity but did not keep a diary, appointment book, calendar or similar record of the time he spent participating in the activity.

Thomas E. Truskowsky and Susan L. Truskowsky v. Commissioner., U.S. Tax Court, T.C. Summary Opinion 2003-130, (Sept. 15, 2003) (100 miles)

Married taxpayers were involved in a cattle breeding operation. The couple did not meet the material participation standard after the court disallowed commuting hours. The court noted that the couple lived 100 miles from where the cattle were located.

Douglas A. Schmuecker v. Commissioner., U.S. Tax Court, T.C. Summary Opinion 2009-32, (Mar. 9, 2009)

Losses claimed by an individual who owned or co-owned race horses were disallowed because the owner kept no written records to adequately substantiate the time that he spent on the activity. Petitioner claimed time spent, 2 to 3 hours per day, doing Internet research on which horses to purchase. Petitioner also claimed time spent communicating with other people about prospective horses.