Bloomberg BNA

Daily Tax Report®

Passive Activity

David Burton of Akin Gump examines the Tax Court's recent analysis in *Leland v. Commissioner*, favoring a lawyer's bid for exception from the passive activity loss rules for his ''material participation'' of more than 100 hours per year in operations of a farm he owns in another state. ''The application of the greater-than-100-hours standard appears to be a fertile area for litigation,'' the author writes.

Tax Court Sheds Light on Counting Hours For the 'Material Participation' Exception

BY DAVID BURTON

A recent Tax Court Opinion, *Leland v. Commissioner*,[1] sheds light on how individual taxpayers should determine their hours worked for purposes of the ''material participation'' exception to the passive activity loss rules.[2]

This issue matters to individual taxpayers seeking to offset losses or tax credits from a side business against their salaries, professional fee income or portfolio investment income.

There are three ways to ''materially participate'' that are relevant in this context:

- an individual spends more than 500 hours a year working at the business—obviously this isn't realistic for most individual investors;
- the individual's participation consists of substantially all of the participation in the activity for all individuals (including individuals who aren't owners); or
- the individual participates in the activity for more than 100 hours and no other individual participates more (including individuals who aren't owners)—this means no one can work even part-time in the business.[3]

There are special rules for real estate professionals who invest in real estate for their own account. Those rules are beyond the scope of this article.

The principles of these exceptions are demonstrated in *Leland*, where the taxpayer had a busy law practice in Jackson, Miss., and owned a cotton farm approximately 15 hours away in Turkey, Texas.

The farmland was farmed under a sharecropping arrangement. However, the taxpayer was responsible for ''maintaining the infrastructure of the farm.''

Reconstructed Time Logs

The taxpayer sought to meet the material participation exception to the passive activity loss rules that requires the taxpayer to work more than 100 hours in the business in the tax year and no individual to work more than the taxpayer.

The taxpayer provided logs showing he worked 372.9 hours and 212.5 hours in 2009 and 2010, respectively. For purposes of his material participation log, he appears to have adopted the legal profession's practice of recording his time in tenth-of-an-hour increments.

[1] *Leland v. Commissioner*, 2015 BL 409682, T.C., No. 17625-13, T.C. Memo 2015-240, 12/14/15 (240 DTR K-2, 12/15/15).

[2] I.R.C. Section 469.

[3] See Temp. Treas. Reg. Section 1.469-5T(a).

David Burton is a partner in the tax practice of Akin Gump Strauss Hauer & Feld LLP in New York. He serves as editor of the firm's blog, Tax Equity Telegraph (http://www.taxequitytelegraph.com/).

 ISSN 0092-6884

The Internal Revenue Service's main objection was that the logs were reconstructed, rather than being prepared contemporaneously with the activity.

The court rebuffed that assertion, saying the taxpayer's ''reconstructed logs, his receipts and invoices related to farm expenses, and his credible testimony are all reasonable means of calculating time spent on farming activity.''

In this vein, the court explained:

> Contemporaneous daily time . . . logs . . . are not required if the taxpayer is able to establish the extent of his participation by other reasonable means. Reasonable means may include . . . appointment books, calendars, or other narrative summaries. The phrase ''reasonable means'' is interpreted broadly . . . . However, a post-event ''ballpark guesstimate'' will not suffice. [Citations omitted.]

Travel Time Included

The court also considered the inclusion of the taxpayer's substantial travel time and determined that it was appropriate.

The IRS didn't dispute his inclusion of travel time in his reconstructed logs. The court said the facts established that his ''travel time was integral to the operation of farming rather than incidental. We are . . . satisfied the [taxpayer's] purpose in traveling long distance to and from Turkey, Texas, was not to avoid the disallowance'' under the passive activity loss rules. [Citations omitted.]

The opinion's discussion shows how subjective the standard for inclusion of travel time as material participation is.

The opinion's discussion above shows how subjective the standard for inclusion of travel time as material participation is: A taxpayer must persuade the arbiter that the travel was ''integral'' to the operation of the business and that the purpose of the travel wasn't to accrue hours to meet the material participation exception to the passive activity loss standard.

In addition, in the case at hand the taxpayer had to clear the hurdle of his sharecropper not spending more hours than him in the tax years in question. The court concluded the sharecropper worked 29-30 hours on the farm in 2009, which included 16 hours to harvest the cotton. The court didn't make a comparable conclusion for 2010 but cited the ''cotton did not develop in 2010'' and the sharecropper abandoned the crop.

The IRS could have tried to assert the sharecropping arrangement was a lease for federal income tax purposes. Leases are per se passive, regardless of the hours spent by a taxpayer working in the leasing business.[4] However, the Tax Court in a 1955 case held, and the Court of Appeals for the Second Circuit agreed, that sharecropping didn't generate rent,[5] meaning that a sharecropping arrangement isn't appropriately characterized as a lease for federal income tax purposes.

Shooting Wild Hogs Versus Attending Church

Finally, the court deemed one activity to be material participation in the farming business even though some residents of Turkey, Texas, may view it as recreation:

> he spends time building traps and baiting them with . . . Kool-Aid to lure [wild] hogs [, that damage the farm's fencing and drainage,] to a specific area, where he waits in a tripod stand with semiautomatic weapons in order to eradicate them.

Although the court determined exercising the taxpayer's Second Amendment right could be related to the farming business, exercising one of the First Amendment rights wasn't:

> We have reduced the hours to subtract time [the taxpayer] listed for attending church in Turkey, Texas. Attending church is not part of the farm activity, and any hours spent either travelling to or at church cannot count towards the hours spent materially participating in the [farming] activity.

The facts of the case don't inform us as to whether the taxpayer logged his time in church as praying for rain for his cotton farm.

More Litigation to Come

The application of the greater-than-100-hours standard appears to be a fertile area for litigation. Less than two weeks after this Tax Court opinion was published, an individual filed a petition in the Tax Court challenging the IRS's disallowance of more than $8.4 million in tax losses for 2011 and 2012, combined.

The losses stemmed from his ownership of a ranch for Akaushi beef cattle. The IRS disallowed the losses due to its determination that the taxpayer hadn't met the material participation standard.[6]

It isn't clear from the petition which of the seven possible ways of materially participating the taxpayer was asserting he satisfied.[7] The petition does assert that the taxpayer spent more than 100 hours in each of 2011 and 2012 working on the ranch. Such an assertion suggests that this taxpayer, like the lawyer/cotton farmer in the Tax Court case discussed above, is trying to satisfy the greater-than-100-hours standard.[8]

However, the petition goes on to assert that the taxpayer ''approved of hiring of employees and consultants'' for the ranch. If there were employees or consultants working on the ranch in the years in dispute, then they would have each had to have worked fewer hours than the taxpayer did in those years in order for the taxpayer to satisfy the greater-than-100-hours standard.[9] That fact isn't included in the petition.

---

[4] I.R.C. Section 469(c)(2). There is an exception, not applicable in this instance, for real estate leasing engaged in by real estate professionals. I.R.C. Section 469(c)(7)(A).

[5] *Webster Corp. v. Commissioner*, 25 T.C. 55, 61 (1955) (*aff'd* 240 F. 2d 164 (2d Cir. 1957)).

[6] *Koch v. Commissioner*, redacted petition, T.C., Docket No. 31957-15 (12/23/15) (02 DTR K-1, 1/5/16).

[7] See Temp. Treas. Reg. Section 1.469-5T(a).

[8] Temp. Treas. Reg. Section 1.469-5T(a)(3).

[9] See id. (''the individual participates . . . not less than the participation of any other individual (including individuals who are not owners of interests in the activity)'').

  DTR ISSN 0092-6884

The lawyer/farmer who won the Tax Court case discussed above represented himself in the case. The court appears to have found him quite persuasive. The gentleman rancher on whose behalf this recent petition was filed may want to retain the lawyer/farmer from Jackson, Miss., as co-counsel.