

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 19, 2022

Third Party Communication: None
Date of Communication: Not Applicable

Number: **202229036**
Release Date: 7/22/2022
Index (UIL) No.: 469.00-00, 469.03-00, 469.08-00
CASE-MIS No.: TAM-114797-21

Branch Chief
Passthroughs & Special Industries

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Corp =

Year 1 =

Year 2 =

ISSUE(S):

Whether an activity qualifies as a significant participation activity (SPA), as defined in § 1.469-5T(c), in a taxable year where the Taxpayer meets the requirement for material participation in an activity under § 1.469-5T(a)(5) (5/10 test) by previously having satisfied the SPA test under § 1.469-5T(a)(4) for material participation in five of the preceding ten taxable years.

CONCLUSION(S):

Section 1.469-5T(c)(1)(ii) provides that an activity is a significant participation activity only if such activity would be an activity in which the individual does not materially participate for the taxable year if material participation is determined without regard to the SPA test in § 1.469-5T(a)(4). Under this rule, where an activity satisfies one of the other six tests for material participation under § 1.469-5T(a) (excluding § 1.469-5T(a)(4)), the activity does not satisfy the requirements to qualify as a SPA under § 1.469-5T(c)(1), even though the remaining requirements (trade or business and hours) are met.

FACTS:

Taxpayer, through multiple grantor trusts, wholly owns Corp, an S corporation. Taxpayer reported each trusts' allocable share of Corp's income on individual income tax return. Corp owned multiple entities, the activities of which are treated as separate ungrouped activities for purposes of § 469. For Year 1 through Year 2, Taxpayer reported the activities as nonpassive. For those activities in which Taxpayer asserts participated more than 100 hours and less than 500 hours, Taxpayer reported these activities as having satisfied the SPA requirements under §1.469-5T(c) and, based on the aggregate of all time Taxpayer spent on SPA activities, Taxpayer claims to have materially participated in those activities under § 1.469-5T(a)(4). For the remaining activities, Taxpayer acknowledges having participated less than 100 hours in each of the activities but reported them as nonpassive based on the 5/10 test in § 1.469-5T(a)(5).¹

During an examination, Exam concluded that certain activities of Taxpayer, which Taxpayer classified as SPAs, instead met the 5/10 test for material participation in the reviewed year by virtue of these activities having satisfied § 1.469-5T(a)(4) (SPA test) in five of the preceding ten years. Based on this conclusion, Exam reclassified these activities because the activities no longer satisfied the SPA requirements under § 1.469-5T(c). This reclassification reduced the number of SPAs in the audit year, such that Taxpayer's aggregate hours for the remaining SPA activities failed to meet the 500 hour requirement of § 1.469-5T(a)(4). Thus, Taxpayer was no longer treated as materially participating in those activities and they were passive activities under section 469.

Exam's Position

Exam bases their adjustment on the language of § 1.469-5T(c)(ii). Exam's position is that an activity cannot be a SPA if it meets any of the other six tests for material participation in § 1.469-5T(a). Here, because Taxpayer is treated as materially participating under the 5/10 test (§ 1.469-5T(a)(5)) for those activities that were SPAs in five prior years, the same activities are not SPAs in the audit year.

¹ Activities that Taxpayer claims met the 5/10 test did not do so by virtue of meeting the SPA test in prior years.

Taxpayer's Position

Taxpayer argues that the language in § 1.469-5T(c)(1)(ii) turns on the meaning of the phrase "if material participation for such year were determined without regard to paragraph (a)(4) of this section." Taxpayer states that this phrase requires a hypothetical determination of whether a taxpayer would be treated as materially participating in an activity in a given year if the material participation tests for such year were applied without regard to the SPA test in § 1.469-5T(a)(4). Taxpayer's asserts that for purposes of the hypothetical determination, material participation for the taxable year must be determined without regard to the application of § 1.469-5T(a)(4) in the taxable year and any other year that is relevant to determining material participation for the taxable year at issue. Taxpayer advocates that because the activities were SPAs and together satisfied the SPA test for material participation under § 1.469-5T(a)(4) in prior years, Taxpayer's prior year material participation is not relevant.

Taxpayer argues that Exam's position leads to the undesired result of having SPAs alternate between the SPA test and the 5/10 test and would create difficulties and inconsistencies for serial entrepreneurs with long standing businesses.

Taxpayer states that the Service's interpretation of § 1.469-5T(c)(1)(ii) asks whether the activity *is* an activity in which the taxpayer materially participates for the year, where the regulation asks whether the activity *would be* an activity in which the taxpayer materially participates if determined without regard to (a)(4). Taxpayer believes that the word choice used in § 1.469-5T(c)(1)(ii) demonstrates that the drafters believed that there would be a situation in which the taxpayer materially participated in the activity under another test but would not materially participate if the determination was made without regard to (a)(4).

Taxpayer also cites to the preamble to the regulations, which provides, with respect to the SPA test, that

[t]his rule is included because the Service believes that an individual who devotes more than 500 hours during a taxable year to several activities, each of which is a significant activity of such individual, should be treated similarly to an individual who devotes an equivalent amount of time to a single activity.

T.D. 8175, 1988-1 C.B. 194. Thus, Taxpayer reasons, it is inconsistent with the intent of the regulation to use another test to prevent a taxpayer from being treated as materially participating under the SPA test, as the tests were created to assist taxpayers who would have difficulty demonstrating material participation under one of the other tests. Taxpayer also argues that because 500 plus hour activities can qualify under both § 1.469-5T(a)(1) and (a)(5) in the same year, treating SPAs differently frustrates the intent by treating a taxpayer engaged in multiple activities in a different manner than a taxpayer involved in a single activity. To demonstrate this frustration, TP cites to the

preamble to the regulations in discussing the 5/10 test, which provides that the 500 hour test of § 1.469-5T(a)(5) was included because

... the Service believes that an activity in which an individual has materially participated over a long period of time or a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood rather than a passive investment...

T.D. 8175, 1988-1 C.B. 194. Taxpayer also argues that the 5/10 test was intended to cause a taxpayer to be treated as materially participating in a longstanding activity in order to prevent such activity from being characterized as passive after the taxpayer ceases to materially participate in the activity.

Taxpayer further points out that in the few reported court opinions which analyze whether a given activity is a SPA, the courts have looked at whether the taxpayer was otherwise treated as materially participating in the activity under § 1.469-5T(a)(1) through (a)(3), but no court has deemed it relevant to discuss whether the taxpayer in such cases was also treated as materially participating in the activity for the year at issue under the 5/10 test. Taxpayer infers from this that the courts did not deem such analysis as relevant to the inquiry because the 5/10 test did not apply. Taxpayer argues that its position is further supported by Example 4 in the regulations which fails to provide facts to exclude material participation under the 5/10 test.²

LAW AND ANALYSIS:

Section 469(a) of the Code disallows the passive activity loss or passive activity credit for the taxable year of any taxpayer subject to § 469.

Section 469(c) provides that, for purposes of § 469, the term "passive activity" means any activity (A) which involves the conduct of any trade or business, and (2) in which the taxpayer does not materially participate.

Section 469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.

Section 469(l)(1) provides that the Secretary shall provide such regulations as may be necessary or appropriate to carry out provisions of § 469, including regulations which specify what constitutes an activity, material participation, or active participation for purposes of § 469.

² Example 4 only illustrates the application of the SPA test for material participation in § 1.469-5T(a)(4). The facts state, without further analysis, that the two activities are significant participation activities under 1.469-5T(c).

Treas. Reg. §§ 1.469-5T(a)(1)-(7) provide quantitative tests for when individuals shall be treated, for purposes of § 469, as materially participating in an activity.

Treas. Reg. § 1.469-5T(a)(4) provides that an individual shall be treated as materially participating in an activity for the taxable year if the activity is a significant participation activity (within the meaning of paragraph (c) of § 1.469-5T) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.

Treas. Reg. § 1.469-5T(a)(5) provides that an individual shall be treated as materially participating in an activity for the taxable year if 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.

Treas. Reg. § 1.469-5T(c)(1) provides that for purposes of § 1.469-5T(a)(4) an activity is a significant participation activity of an individual if and only if such activity (i) is a trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and (ii) would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this § 1.469-5T.

Treas. Reg. § 1.469-5T(c)(2) provides that an individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

There are no court opinions addressing whether an activity meets the 5/10 test solely by having been a SPA for the requisite number of prior years. Although not directly on point, the Tax Court has discussed the SPA test in relation to the other six tests. In Scheiner v. Commissioner, T.C. Memo 1996-554 at *8, the Court provides a general explanation of the SPA rules, stating, “[a] significant participation activity is one in which the taxpayer participates for more than 100 hours, but which fails to constitute material participation under one of the other six tests [emphasis added].” In Gregg v. United States, 186 F.Supp.2d 1123, 1130 (D. Or. 2000), the District Court held that one of plaintiff's activities was not a SPA as the plaintiff exceeded the 500-hour minimum standard of § 1.469-5T(a)(1), and thus the activity could not be a SPA under § 1.469-5T(a)(1).

Section 1.469-5T(c) provides the requirements to ascertain whether an activity is a significant participation activity for purposes of determining material participation under § 1.469-5T(a)(4). Section 1.469-5T(c)(1) clearly states that an activity is a significant participation activity “if and only if” such activity meets the two requirements in (c)(i) and (ii). The parties agree that Taxpayer's activities are trade or business activities and meet the requirement of subparagraph (c)(1)(i). As to the second requirement, we agree with Exam's conclusion. For those activities in which Taxpayer materially

participated under § 1.469-5T(a)(4) in any five years during the preceding ten years, cannot satisfy the requirement under § 1.469-5T(c)(1)(ii) because Taxpayer is otherwise treated as materially participating in each of those activities under § 1.469-5T(a).

Taxpayer's position that the language in § 1.469-5T(c)(1)(ii) provides that material participation for a taxable year is determined by disregarding whether Taxpayer satisfied § 1.469-5T(a)(4) in the tested taxable year and any other relevant year, is unsupported by the language. The language of § 1.469-5T(c)(1)(ii) specifies that the relevant inquiry is whether the taxpayer materially participated for "the taxable year" and that determination is being made "for such year" without taking § 1.469-5T(a)(4) into account. Section 1.469-5T(c)(1)(ii) does not say to disregard § 1.469-5T(a)(4) for every previous year where a taxpayer was treated as having materially participated under that test.

Thus, an activity that met the requirements of § 1.469-5T(a)(4) in any five of the last ten taxable years satisfies the 5/10 test under § 1.469-5T(a)(5) for material participation in the taxable year and no longer satisfies the requirement in § 1.469-5T(c)(1)(ii). Once the activity no longer meets the 5/10 test, the activity may, provided it otherwise meets the requirements of § 1.469-5T(c)(1), again be classified as a SPA.

The Service acknowledges that § 1.469-5T(c)(1)(ii) imposes an additional requirement on SPA activities, one that potentially removes an activity from being treated as a SPA in the current tax year based on participation in prior years, as is the case here. The additional requirement in § 1.469-5T(c)(1)(ii) results in a significant participation activity shifting out of the SPA test and into the 5/10 test because under § 1.469-5T(c)(1)(ii) an activity cannot be both a SPA and satisfy another material participation test. In contrast, for example, an activity that satisfies the 500 hour test also satisfies the 5/10 test in the same year because there is no similar restriction. The difference in treatment is a direct result of the SPA test having a separate qualifying section in § 1.469-5T(c)(1), where there is no such additional qualifying section for (a)(1).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.