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Material Participation Under the Passive Activity Loss Preventions

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MATERIAL PARTICIPATION UNDER THE PASSIVE ACTIVITY LOSS PROVISIONS

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**On February 19, 1988, the Internal Revenue Service issued temporary and proposed regulations which defined the term "material participation" for purposes of section 469. *See* Treas. Reg. § 1.469-5T. The regulations were promulgated after this article had been submitted for publication.

I. INTRODUCTION

By enacting the passive activity loss provisions, the Tax Reform Act of 1986 completed a process that had begun in 1976 to curb tax shelter abuses.[1] Section 469 sets forth the passive activity loss provisions.[2] Although section 469 was enacted into the Internal Revenue Code (the Code) by the 1986 legislation, the operation of the section revolves around a term that is familiar to the Code; that term is "material participation."[3] The broad reach of the passive activity loss provisions makes the definition of material participation as used in section 469 of vital interest to every tax practitioner.[4]

Tax practitioners have been concerned with the definition of material participation since section 469 was first proposed, and have specu-

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1. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976). One of the major objectives of the Tax Reform Act of 1976 was to improve the equity of the tax system. While Congress wanted to retain tax preferences, it also wanted to eliminate tax shelter abuses and the inefficient allocation of resources caused by tax shelters. H.R. REP. No. 658, 94th Cong., 2d Sess. 7-9, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 2901-04; S. REP. No. 938, 94th Cong., 2d Sess. 7-9, 1976 U.S. CODE CONG. & ADMIN. NEWS 3443-46; STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 2-3 (Comm. Print 1976) [hereinafter JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976].

In fact, the House bill included a provision for "limitation on artificial losses" that allowed certain artificial deductions to be taken only against related income. H.R. REP. No. 658, 94th Cong., 2d Sess. 25, 1976 U.S. CODE CONG. & ADMIN. NEWS 2919. However, the final bill deleted the limitation on artificial losses because of its extreme complexity and adverse economic impact. Instead, Congress attempted to curb tax shelter abuses with the minimum tax provisions, the at-risk rules, the recapture rules, the capitalization provisions, and the partnership provisions. S. REP. No. 938, 94th Cong., 2d Sess. 39, 1976 U.S. CODE CONG. & ADMIN. NEWS 3475; H.R. REP. No. 1515, 94th Cong., 2d Sess. 407-08, 1976 U.S. CODE CONG. & ADMIN. NEWS 4118-19.

2. Tax Reform Act of 1986, Pub. L. No. 514, 99th Cong., 2d Sess. § 501 (1986) (codified at I.R.C. § 469 (1986)) (TRA '86). All references are to the Internal Revenue Code of 1986 unless otherwise indicated.

3. *See, e.g.*, I.R.C. § 147(c)(2) (requiring material participation by a first-time farmer in order for a private activity bond to be classified as a qualified bond under I.R.C. § 103); I.R.C. § 163(d)(5) (defining "property held for investment" for purposes of the limitation on investment interest as including an interest in an activity involving the conduct of a trade or business that is not a § 469 passive activity, and with respect to which the taxpayer does not materially participate as defined under § 469); I.R.C. § 1402(a)(1) (including rental income derived by an owner or tenant within the term "net earnings from self-employment" where there is material participation by the owner or tenant); I.R.C. § 2032A (requiring material participation in order to qualify for special use valuation).

4. Richard M. Lipton, Chairman of the ABA Section of Taxation's Special Task Force on Passive Activity Losses, has stated that the passive activity loss rules reach far beyond their intended scope and will require careful attention in many situations that do not involve tax shelters. Lipton, *Fun and Games With Our New PALs*, 64 TAXES 801, 801 (1986).

lated whether material participation under section 469 would be measured by the definitions established under section 1402(a), relating to the self-employment tax, and section 2032A, relating to valuation of farm and small business property for estate tax purposes.[5] Material participation is a key term in both sections 1402(a) and 2032A. Legislative history indicates that the material participation standard under section 469 is based on the material participation standards under sections 1402(a) and 2032A. However, the section 469 standard is to be modified in accordance with the purpose of the passive activity loss provisions.[6] Nevertheless, the authority under the self-employment provisions and section 2032A should prove helpful in defining material participation under section 469.

This paper analyzes the parameters of material participation in relation to the statutory purpose of the passive activity loss provisions. The article first examines section 469 and its legislative history to establish an initial analytical framework. Since material participation is a familiar term in the Code, the article will also examine other Code sections that contain the term. This examination will determine whether the definition of material participation under these other sections crosses over into section 469, or whether their legislative purposes differ from the legislative purpose of section 469 so that a similar meaning for section 469 would be inappropriate. The article will then attempt to establish parameters for the term material participation as used under section 469.

II. OVERVIEW OF SECTION 469

A. *Statutory Purpose of Section 469*

Section 469 was enacted to curb investments in tax shelters.[7] When enacting the Tax Reform Act of 1986 (TRA '86), Congress noted the prevalence of tax shelters and their adverse consequences. Congress was concerned with the public perception of an inequitable system in which only the naive and unsophisticated paid tax.[8] Congress also

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5. The ABA Tax Section's Special Task Force on Nonparticipatory Business Losses submitted 48 issues regarding passive activity limitations to the Senate Finance Committee staff while the bill was being drafted. One of the questions presented was whether the existing standards under I.R.C. §§ 1402 & 2032A would be adequate for purposes of defining material participation. Tax Notes Today, June 3, 1986, L-286 (1986).

6. S. REP. No. 313, 99th Cong., 2d Sess. 732 (1986).

7. *Id.* at 713-14; STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., 1st SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 209-10 (Comm. Print 1987) [hereinafter JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986].

8. S. REP. No. 313, 99th Cong., 2d Sess. 713-14 (1986).

observed that tax shelters diverted investment capital from productive activities to activities with tax avoidance objectives, and rewarded investors even though the return was non-economic.[9] This situation retarded growth in sectors of the economy that had a good potential for expansion.[10] Congress wanted to encourage activities that provided a higher pre-tax economic return.

Tax shelter activity also conflicted with another objective of TRA '86. Congress wanted to lower the tax rates, but tax shelters eroded the federal tax base. Thus, a low federal tax base coupled with low tax rates would have provided insufficient revenue for the national economy.[11]

B. *Operation of Section 469*

Section 469 carries out the congressional objective of curbing tax shelter investments by barring the deduction of passive activity losses against income from nonpassive activities.[12] Section 469 adopts an aggregate concept. The amount by which aggregate losses from all passive activities for a taxable year exceeds the aggregate income from all passive activities for such year is disallowed as a deduction.[13]

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9. *Id.* at 714-16.

10. *Id.* at 716.

11. *Id.* at 714. TRA '86 has been referred to as the "happy marriage." Liberals liked the Act because it closed loopholes, and conservatives liked it because it lowered tax rates. *See* 31 TAX NOTES (TAX ANALYSTS) 757 (May 26, 1986).

12. The prohibition on the use of passive losses against other income was originally suggested by the American Law Institute in its Subchapter K project of 1982. 31 TAX NOTES (TAX ANALYSTS) 552 (May 12, 1986).

13. I.R.C. § 469(a)(1)(A), (d)(1). Section 469 also limits the sum of all credits from passive activities for the taxable year to the tax liability allocable to the passive activities. *See id.* § 469(a)(1)(B), (d)(2).

Section 469 applies to individuals, estates, trusts, closely held C corporations, and personal service corporations. *See id.* § 469(a)(2). Closely held C corporations are defined by reference to the stock ownership rules for personal holding companies and generally involve corporations in which five or fewer individuals directly or indirectly own 50% of the stock. *See id.* § 469(j)(1). Personal service corporations involve corporations whose principal activity is the performance of personal services when such services are substantially performed by owner-employees. *See id.* § 469(j)(2). Partnerships and S corporations are not subject to passive activity restrictions. Instead, the income and deductions from these pass-through entities are tested at the individual level. *See* S. REP. No. 313, 99th Cong., 2d Sess. 720 (1986).

An exception is made to the aggregate concept with regard to publicly traded partnerships. Section 10212 of the Revenue Act of 1987 added new § 469(k) to the Code and redesignated subsections (k) and (l) of § 469 as subsections (l) and (m), respectively. Omnibus Budget Reconciliation Act, Pub. L. No. 203, 100th Cong., 1st Sess. § 10212 (1987). New § 469(k) requires the passive activity loss rules to be applied separately to each publicly traded partnership. Accordingly, each publicly traded partnership must report its income and loss separately from

All income is thus placed in the following three categories: (1) income from passive activities (e.g., income from a limited partnership interest); (2) active income (e.g., salaries and bonuses); and (3) portfolio income (e.g., dividends and interest).[14] Losses from passive activities can be offset only against passive income. Generally, the passive activity losses cannot be applied against income in the other two categories.[15] To the extent that passive activity losses are disallowed, the unused passive loss is carried forward indefinitely and treated as a deduction allocable to passive activities in subsequent taxable years.[16] Any remaining suspended losses from a passive activity are deductible in full when the taxpayer disposes of all interest in the activity in a taxable transaction.[17]

Passive activities fall into the following two categories: (1) any trade or business in which the taxpayer does not materially participate; and (2) any rental activity, whether or not the taxpayer materially participates.[18] An individual taxpayer materially participates in an ac-

every other publicly traded partnership and every other passive activity in which the taxpayer is involved, resulting in a situation where the income of a publicly traded partnership cannot be reduced by losses from other publicly traded partnerships or other passive activities. *See generally* Lipton, *Section 469 and PTPs: Impact of the Omnibus Reconciliation Act of 1987*, 38 TAX NOTES (TAX ANALYSTS) 183 (Jan. 11, 1988). Furthermore, if a publicly traded partnership has both portfolio income and losses from business activities, the partners' shares of losses from business activities may not be applied against the shares of portfolio income. S. REP. NO. 76, 100th Cong., 1st Sess. 186-87 (1987).

14. I.R.C. § 469(e)(1). An issue is raised with regard to an S corporation with accumulated earnings and profits when distributions in excess of the accumulated adjustments account are made to a shareholder who is not a material participant. The question is whether the dividend is passive income or portfolio income. Walters, *Passive Loss and Interest Expense Provisions*, 18 TAX ADVISER 99 (1987). The Internal Revenue Service has ruled that such distributions will constitute portfolio income under § 469(e)(1)(A), since the distributions are dividends under § 1368(c)(2). *See* Priv. Ltr. Rul. 8,752,017 (Sept. 25, 1987).

According to the legislative history of new § 469(k), a partner's share of net income from a publicly traded partnership will be treated as portfolio income. However, suspended net losses of the publicly traded partnership can be applied against net income from the partnership in the next year; i.e., the net income is treated as passive income for carryover purposes. S. REP. No. 76, 100th Cong., 1st Sess. 186 (1987).

15. Notwithstanding the general rules, § 469 affords more favorable treatment to closely held C corporations than to individuals and personal service corporations. With regard to closely held C corporations, a passive activity loss can be offset against non-portfolio income. A similar rule applies to credits. *See* I.R.C. § 469(e)(2).

16. *Id.* § 469(b).

17. *Id.* § 469(g).

18. *Id.* § 469(c)(1)-(2). The term "passive activity" does not include any working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with regard to the interest. *Id.* § 469(c)(3). The "working interest" exception was a last-minute amendment for the purpose of persuading votes. The oil state senators on the Senate Finance Committee threatened to kill the bill unless the provision was included. *See* TAX NOTES, *supra* note 12, at 551.

tivity only by involvement in the operations of the activity on a regular, continuous, and substantial basis.[19] The requirement of regular, continuous, and substantial participation applies regardless of whether the individual owns an interest in a proprietorship or a passthrough entity such as a partnership or an S corporation.[20] Furthermore, the individual taxpayer must materially participate throughout the taxable year.[21] Participation by the taxpayer's spouse is imputed to the taxpayer.[22] The Secretary is granted specific authority to prescribe regulations that specify what constitutes material participation for purposes of section 469.[23]

A limited exception to the passive activity loss rules is made for rental real estate activity involving a natural person. An individual who actively participates in the rental activity may annually deduct up to $25,000 of rental losses to the extent that the losses exceed passive income.[24] However, this exception is phased out for taxpayers with adjusted gross incomes exceeding $100,000.[25]

The active participation standard is less stringent than the material participation standard. Active participation may be satisfied without regular, continuous, and substantial involvement in operations.[26] In

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19. I.R.C. § 469(h)(1). In the case of trusts and estates, material participation is based on whether the fiduciary meets the material participation standard. S. REP. No. 313, 99th Cong., 2d Sess. 735 (1986). Material participation in a grantor trust is determined at the grantor level. *Id.* at 735 n.21. In comments to the Treasury Department, tax practitioners had urged that a "qualified subchapter S trust" under § 1361(d)(3) be treated in the same manner as grantor trusts for the purpose of determining material participation. 34 TAX NOTES (TAX ANALYSTS) 1053 (Mar. 16, 1987). The Staff of the Joint Committee on Taxation adopted this position in its explanation. JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 242 n.33.

Personal service corporations materially participate in an activity if one or more shareholders holding stock that represents more than 50% of the value of outstanding stock materially participate in the activity. In addition to the 50% test, a closely held C corporation must meet a second test that looks to services furnished by non-owner employees. *See* I.R.C. § 469(h)(4). A limited partner, however, is deemed not to materially participate in the activity of the limited partnership. *See id.* § 469(h)(2).

20. S. REP. No. 313, 99th Cong., 2d Sess. 720 (1986).

21. *Id.* at 730.

22. I.R.C. § 469(h)(5).

23. *Id.* § 469(l)(1).

24. *Id.* § 469(i)(1)-(2).

25. *Id.* § 469(i)(3). The taxpayer's interest in the rental activity must equal 10% or more of the value for the taxpayer to actively participate. A limited partner is deemed not to actively participate in the limited partnership's rental activity. *See id.* § 469(i)(6).

26. S. REP. No. 313, 99th Cong., 2d Sess. 737 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 244.

this area, the taxpayer can meet the standard by involvement in general management decisions.[27]

C. *Importance of Material Participation Under Section 469*

Although Congress wanted to curb the investments in tax shelters, it did not want to eliminate all tax preferences.[28] Instead, Congress wanted to restrict the availability of tax preferences to a certain category of taxpayers. In section 469, Congress used material participation as a tool for identifying this category of taxpayers.

For two reasons, Congress considered it inappropriate to eliminate all tax preferences. First, Congress believed that many tax preferences were socially or economically beneficial and often advanced the objectives of Congress.[29] Second, Congress noted the impossibility of designing a tax system that measures income perfectly. Even if such a system could be devised, the rules would create undue complexity and present serious difficulty in both compliance and administration.[30] Therefore, Congress opted to retain many of the tax preferences.

Even though it retained the preferences, Congress wanted to limit their availability. Congress observed that many taxpayers structured transactions specifically to take advantage of tax preferences, and this situation often led to the undermeasurement or deferral of income from activities that Congress did not target to receive the benefit of tax preferences.[31] Instead, Congress intended to benefit and provide incentives to taxpayers *active* in the businesses to which the preferences were directed.[32] The legislative history states:

> The committee believes that, in order for tax preferences to function as intended, their benefit must be directed

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27. S. REP. No. 313, 99th Cong., 2d Sess. 737-38 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 244-45.

28. "Tax preferences" refer to exclusions, deductions, and credits that are provided as a matter of legislative grace. TRA '86 reduced or eliminated some tax preference items; for example, it repealed the investment tax credit. *See* I.R.C. § 49(a). However, Congress did not eliminate all tax preferences. For instance, TRA '86 modified but retained the credit for qualified rehabilitation expenditures. *See id.* §§ 46(a)(3), (b)(4), 48(g), (o), (q)(3).

29. S. REP. No. 313, 99th Cong., 2d Sess. 715 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 211.

30. S. REP. No. 313, 99th Cong., 2d Sess. 715 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 211.

31. S. REP. No. 313, 99th Cong., 2d Sess. 715 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 211.

32. S. REP. No. 313, 99th Cong., 2d Sess. 715 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 211.

> primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences relate. The committee also believes that it is appropriate to encourage nonparticipating investors to invest in particular activities, by permitting the use of preferences to reduce the rate of tax on income from those activities; however, such investors should not be permitted to use tax benefits to shelter unrelated income.[33]

Congress had several reasons for focusing on a taxpayer's participation in an activity. A taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value.[34] This type of participation attracts capital to segments of the economy with good economic growth potential. The material participation standard also distinguishes different types of taxpayer activities.[35] The passive investor seeks a return on invested capital; this return on capital includes returns in the form of reductions in the taxes owed on unrelated income.[36] For the passive investor, a material participation standard reduces the importance of the tax-reduction features of an investment and increases the importance of the economic potential.[37] This type of investment criteria is more likely to promote an efficient allocation of resources within the economy.

When Congress limited passive activity losses, it addressed a fundamental aspect of the tax shelter problem.[38] Transactions are often structured to take advantage of tax preferences. These transactions are commonly marketed as devices for sheltering unrelated sources of positive income to investors who do not intend to participate in the transaction.[39] By utilizing the material participation standard as a bar against the use of passive losses to offset positive income sources, Congress thought it would significantly reduce the tax shelter problem.[40]

Since the material participation standard has been described as unclear and confusing,[41] the tax practitioner should welcome any source

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33. S. REP. No. 313, 99th Cong., 2d Sess. 716 (1986).
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. Lipton, *supra* note 4, at 810.

of guidance in this area. The legislative history indicates that the material participation standard under section 469 is based on the material participation standards under sections 1402(a) and 2032A. Certainly, an examination of the existing authority under these sections will assist in defining material participation under section 469.

III. MATERIAL PARTICIPATION UNDER SECTION 1402 AND THE SOCIAL SECURITY ACT

The self-employment provisions of the Code and the Social Security Act use the term material participation to differentiate between rental income that falls either within or outside the term "net earnings from self-employment." Since the Social Security Act functions as a relief provision, courts have broadly construed the term "material participation" to bring claimants within the purview of the legislation. In fact, the judicial construction requires much less claimant involvement than do the regulations promulgated under either the Code or the Social Security Act.

Chapter 2 of Subtitle A of the Code concerns the tax on self-employment income. Section 1401 imposes a tax on self-employment income to finance the federal Old Age and Survivors Insurance Trust Fund.[42] The Social Security Act provides for distribution of benefits from the fund to qualifying individuals.[43] The old-age and survivors insurance program was designed to provide partial protection against loss of earned income upon the retirement, disability, or death of a worker.[44]

Section 1402(a) defines "net earnings from self-employment" for purposes of the self-employment tax, and section 211(a) of the Social Security Act defines the same term for purposes of the Social Security Act. Both the Code and the Social Security Act generally exclude rents from the term "net earnings from self-employment." Nevertheless, both the Code and the Social Security Act include rents received by taxpayers who materially participate in agricultural production on the rented land as being within "net earnings from self-employment."[45]

Congress intended to protect persons whose income was diminished or lost because of old age or disability. Rents, however, are not normally subject to reduction because of old age or disability, since they

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42. *See* I.R.C. ch. 2.

43. *See* 42 U.S.C. ch. 7 (1982).

44. S. REP. No. 2133, 84th Cong., 2d Sess. 1, 1956 U.S. CODE CONG. & ADMIN. NEWS 3877; Celebrezze v. Miller, 333 F.2d 29 (5th Cir. 1964); Celebrezze v. Maxwell, 315 F.2d 727 (5th Cir. 1963). *See generally* Note, *Material Participation and the Valuation of Farm Land for Estate Tax Purposes Under the Tax Reform Act of 1976*, 66 KY. L.J. 848, 863 (1978).

45. *See* I.R.C. § 1402(a)(1); 42 U.S.C. § 411(a)(1) (1982).

do not depend on the recipient's physical labor. Since the purpose of the social security legislation was not to protect individuals whose income continues in spite of old age or disability, rents are excluded from net earnings from self-employment. In contrast, landlords who are actively involved in production activities suffer an income loss with the onset of old age or disability. The rationale for the material participation exception to the general exclusion rule is that this type of rental income depends on the taxpayer's activity.[46]

A. *Section 1402*

Under section 1402(a)(1), "net earnings from self-employment" includes rental income derived under an "arrangement" between the taxpayer and tenant that calls for the taxpayer to materially participate in either management or agricultural production. The arrangement may be written or oral,[47] and the contemplated material participation must actually occur.[48]

As indicated above, section 1402(a)(1) contemplates the following two kinds of participation: (1) material participation in the production of agricultural commodities and (2) material participation by managing the production of the commodities.[49] However, the taxpayer's participation does not have to be material with respect to only production or only management; the taxpayer may participate in both production and management to such a degree that the combination of the activities will constitute material participation.[50]

The regulations under section 1402 provide that the term "production" refers to both the physical work performed and the provision of capital, although material participation may not be achieved solely by providing capital.[51] The regulations under section 1402 define production as:

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46. S. REP. No. 2133, 84th Cong., 2d Sess. 8, 1956 U.S. CODE CONG. & ADMIN. NEWS 3884; Celebrezze v. Miller, 333 F.2d 29 (5th Cir. 1964); Celebrezze v. Maxwell, 315 F.2d 727 (5th Cir. 1963). *See generally* Note, *supra* note 44, at 863.

47. Treas. Reg. § 1.1402(a)-4(b)(2)-(3) (1963).

48. *Id.* § 1.1402(a)-4(b)(4) (1963). Section 1402(a)(1) also provides that the taxpayer may not achieve material participation through an agent. *See id.* § 1.1402(a)-4(b)(5). When originally enacted, neither § 1402(a) nor § 211(a) of the Social Security Act precluded material participation through an agent. In 1974, §§ 1402(a) & 211(a) of the Social Security Act were amended to require that owner participation must be determined without regard to any activity of an agent. Pub. L. No. 93-368, § 10(b), 88 Stat. 422 (1974).

49. McCormick v. Richardson, 460 F.2d 783 (10th Cir. 1972).

50. Treas. Reg. § 1.1402(a)-4(b)(3)(i) & (4) (1963).

51. *Id.* § 1.1402(a)-4(b)(3)(ii).

> [S]ervices performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and includes advising and consulting, making inspections, and making decisions as to matters such as rotation of crops, the type of crops to be grown, the type of livestock to be raised and the type of machinery and implements to be furnished.[52]

The regulations rely heavily on inspection, advising, and consultation. If the taxpayer periodically advises or consults with the other party, and periodically inspects the production activities, a strong inference of material participation will arise.[53]

The Internal Revenue Service (the Service) has indicated that material participation will be determined on a fact and circumstance basis. Inspection alone is insufficient for material participation unless relevant to the production activity.[54] The Service also states that the tenant's expertise may constitute evidence of the taxpayer's reduced participation in management decisions.[55]

B. *The Social Security Act*

The Social Security Act provides for the distribution of payments financed by the self-employment tax.[56] Accordingly, the provisions of section 211(a)(1) of the Social Security Act are almost identical to those of section 1402(a)(1). Likewise, the social security regulations are substantially similar to the regulations promulgated under section 1402.[57]

The social security regulations require both an "arrangement" for material participation and actual participation to meet the material participation standard.[58] The regulations also provide for the same two types of participation as the section 1402 regulations: production and management. In fact, "production" and "management of production" are defined alike under both the social security regulations and the

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52. *Id.* § 1.402(a)-4(b)(3)(iii).

53. *Id.* § 1.402(a)-4(b)(3)(iii) & (4).

54. Rev. Rul. 57-58, 1957-1 C.B. 270; Treas. Reg. § 1.1402(a)-4(b)(6), Ex. (4) (1963).

55. Priv. Ltr. Rul. 8,425,035 (Mar. 19, 1984) (observing that the taxpayer did not have experience or expertise in the operation of a farm and deferred to the tenant's expertise and unilateral decisionmaking).

56. *See* 42 U.S.C. §§ 401-431 (1982); *see generally* Note, *Taxation: Valuation of Farmland for Estate Tax Purposes, Qualifying for I.R.C. Section 2032A Special Use Valuation*, 23 WASHBURN L.J. 638, 656 (1984).

57. 20 C.F.R. § 404.1082 (1985).

58. *Id.* § 404.1082(c)(1).

section 1402 regulations.[59] The social security regulations also indicate that periodic advice, consultation, and inspection will constitute strong evidence of material participation.[60]

C. *Judicial Construction*

Because the self-employment tax provisions and the Social Security Act are symmetrical and complementary, commentators suggest that material participation may be interpreted similarly under both provisions.[61] Few cases have interpreted material participation under section 1402, but considerable case law exists under section 211(a)(1) of the Social Security Act.

The courts have generally held that the Social Security Act should be liberally construed.[62] Legislative history indicates the policy is to maximize coverage under the Act.[63] The Fourth Circuit Court of Appeals noted that the legislation progressively broadened the old age and survivors insurance plan. The court stated: "The concept of the statute is more inclusive, and the design is, by a comprehensive contributory insurance plan, to avert the personal hazards and the social problems which often, but happily not always, attend old age."[64] In *Vance v. Ribicoff*,[65] the court held that an eighty-two year old widow materially participated under the Social Security Act when she sharecropped with a competent farmer and furnished various materials and supplies. Even though the widow had paid self-employment tax on the income in question, the government denied her claim for social security benefits. The court found it "shoddy business for one branch of the federal government to retain taxes paid on the premises that the taxpayer *was* self-employed, while another denies social security benefits on the premise that taxpayer *was not* self-employed."[66] The courts thus appear willing to stretch the definition of material participation equitably to provide social security coverage to a claimant.

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59. *Id.* § 404.1082(c)(2).

60. *Id.* § 404.1082(c)(3).

61. Normand, *Special Use Valuation of Farmland for Estate Tax Purposes: Arrangements for Material Participation*, 30 BAYLOR L. REV. 245, 251 (1978); Zumbach, *Section 2032A — Special Use Valuation*, Tax Mgmt. (BNA) 1st Ser., § 445, at A-7 (1986).

62. Foster v. Celebrezze, 313 F.2d 604, 607 (8th Cir. 1963); Harper v. Flemming, 288 F.2d 61, 64 (4th Cir. 1961); Henderson v. Flemming, 283 F.2d 882, 887-88 (5th Cir. 1960).

63. S. REP. No. 2133, 84th Cong., 2d Sess. 1, 1956 U.S. CODE CONG. & ADMIN. NEWS 3878; Bryant v. Celebrezze, 229 F. Supp. 329, 334 (E.D.S.C. 1964).

64. Harper v. Flemming, 288 F.2d 61, 64 (4th Cir. 1961).

65. 202 F. Supp. 790, 795 (E.D. Tenn. 1961).

66. *Id.* at 796.

The courts have more liberally interpreted the term "production" than have the regulations under both section 1402 and the Social Security Act. The regulations required physical work for production, and more than mere provision of capital.[67] However, the Fifth Circuit Court of Appeals has consistently held that financial contributions alone may constitute material participation in an appropriate case.

In *Henderson v. Flemming*,[68] the Fifth Circuit Court of Appeals held that a ninety-one year old invalid widow materially participated in production or management of production through her son, who acted as her agent. In dicta, the court made the following statement:

> [W]e know at least today that agriculture is or may be big business. It takes more than land and a willing hand. It takes working capital, frequently in considerable amounts. An owner of land who is required to (and does) furnish substantial amounts of cash, credit or supplies toward this mutual undertaking which are reasonably needed in the production of the agricultural commodity and from the success of which he must look for actual recoupment likewise makes a "material participation."[69]

In *Celebrezze v. Maxwell*,[70] the same court cited the *Henderson* dictum, but found that a twenty-five percent financial contribution was so small compared to the tenants' contribution as to preclude material participation. In *Celebrezze v. Miller*,[71] an eighty-two year old landlord furnished one-third of the costs of fertilizer, poison, and labor. The Fifth Circuit Court of Appeals relied on the *Henderson* dictum to find material participation. Other courts have not challenged the Fifth Circuit court's rationale.[72]

Courts have generally been lenient regarding the taxpayer's proximity to the farm. In *Conley v. Ribicoff*,[73] the owner lived in California and the farm was in South Dakota. The court held that material participation existed under a sharecrop arrangement because of the

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67. *See supra* note 51 and accompanying text.

68. 283 F.2d 882, 889 (5th Cir. 1960).

69. *Id.* at 888.

70. 315 F.2d 727, 730 (5th Cir. 1963).

71. 333 F.2d 29 (5th Cir. 1964).

72. *Contra* Bridie v. Ribicoff, 194 F. Supp. 809, 815 (N.D. Iowa 1961) (although the court suggested that the language in *Henderson* was perhaps unnecessary, the court stated that it need not decide whether the advancement of capital in and of itself can constitute material participation); Bryant v. Celebrezze, 229 F. Supp. 329, 336 (E.D.S.C. 1964) (rejecting the dictum in *Henderson* entirely).

73. 294 F.2d 190 (9th Cir. 1961).

owner's role in the decisionmaking process. In *Hoffman v. Gardner*,[74] a resident of Missouri owned Iowa land that was farmed under a sharecrop arrangement. The owner lived four hundred miles away and only visited the farm for one week during the growing season. The court nonetheless held that material participation existed because the owner exercised managerial control through telephone and mail communication. These cases show that on-site presence is not a requirement of material participation under the Social Security Act and section 1402.

Courts also give weight to the expertise of the parties. In *Celebrezze v. Maxwell*,[75] the court found that the owner did not materially participate under a sharecrop arrangement since the tenants were competent farmers and not dependent on the owner's advice in running the farm. In *Bridie v. Ribicoff*,[76] the court focused on the tenants' inexperience, and found that the owner had materially participated. The court declined to hold that plaintiff's role in the decisionmaking was insignificant when inexperienced tenants were on the farm. In *Bryant v. Celebrezze*,[77] the court considered the expertise of the owner and held that the owner did not materially participate because he did not possess the requisite skills for farm management. The court in *Celebrezze v. Wifstad*,[78] however, noted the owner's long experience with dry-farming operations in finding that the owner materially participated by making important management decisions.

Finally, courts emphasize the land owner's decisionmaking authority. In *Conley v. Ribicoff*,[79] the owner of a South Dakota farm lived in California while the farm was operated under a sharecrop arrangement. The farmland itself was the owner's only capital contribution. The owner only visited the farm twice each year. However, the owner drafted the farm plan for each year and exercised final management authority over what to plant and where to plant it. The court noted that the vital inquiry was whether a decision or plan was of substantial importance to the farm operation. The Ninth Circuit Court of Appeals held that material participation could exist solely because of the owner's decisionmaking authority. In *Hoffman v. Gardner*,[80] the

74. 369 F.2d 837 (8th Cir. 1966).

75. 315 F.2d 727 (5th Cir. 1963).

76. 194 F. Supp. 809, 814-15 (N.D. Iowa 1961).

77. 229 F. Supp. 329, 337 (E.D.S.C. 1964).

78. 314 F.2d 208, 216-18 (8th Cir. 1963).

79. 294 F.2d 190 (9th Cir. 1961).

80. 369 F.2d 837 (8th Cir. 1966); *contra* Hoffman v. Ribicoff, 305 F.2d 1, 8-9 (8th Cir. 1962). The Eighth Circuit ruled on two *Hoffman* decisions. In the first *Hoffman* decision, the court held that making a farm plan at the beginning of the season was not sufficient in itself to establish material participation.

Eighth Circuit Court of Appeals held that a taxpayer who used letters and telephone conversations to supervise a farm under a sharecrop arrangement materially participated although the owner lived four hundred miles away and only visited for one week during the growing season. The court noted that the owner made the important decisions about crop production.[81] In *McCormick v. Richardson*,[82] the Tenth Circuit Court of Appeals held that the phrase "management of production" meant the determination of activity to be conducted that would affect production. The court observed that the owner actively participated in every important decision that affected production, and in the event of disagreement, the owner's decision would prevail.[83]

In summary, the section 1402 and social security regulations give considerable weight to advising, consulting, and inspecting. In contrast, the primary emphasis of the cases is on the final decisionmaking authority and the importance of those decisions in the overall operation. Courts consider advising, consulting, and inspecting as only factors in making the final decision.[84]

IV. Material Participation Under Section 2032A

In the estate tax area, section 2032A uses material participation as a device to limit the availability of the special use valuation rules. A certain level of participation must be reached by the decedent or a member of the decedent's family before the estate qualifies for this exception to the general valuation rules. Because material participation acts as a limitation in the section 2032A context, courts place great weight on the regulations promulgated under section 2032A. These regulations require a higher level of involvement than case law requires under the self-employment provisions.

Prior to 1976, many devisees of farmland and property used in small businesses were forced to sell part of the land or borrow money to pay the estate taxes. Several factors created this dilemma. First, many farms had increased in size. Second, the value of land had increased due to inflation.[85] Under the traditional method of valuing real

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81. *See* Foster v. Celebrezze, 313 F.2d 604, 608-09 (8th Cir. 1963) (lease provided landlord with broad management powers).

82. 460 F.2d 783, 787 (10th Cir. 1972).

83. *See* Colgate v. Gardner, 265 F. Supp. 987 (S.D. Ohio 1967) ("elderly maiden lady" who made important management decisions materially participated even though consultations and inspections were short and irregular).

84. Normand, *supra* note 61, at 263; Zumbach, *supra* note 61, at A-7 to A-8; Note, *supra* note 56, at 658.

85. *See generally* Note, *supra* note 44, at 848-57; Note, *supra* note 56, at 638-44.

property for estate tax purposes, land was valued based on its highest and best use.[86] The above factors created large gross estates for farmers and certain small business owners. However, these estates lacked the liquidity needed to pay the estate taxes. Congress perceived this situation as a threat to the family farm and the small family business.[87]

A. *Section 2032A*

In order to relieve the estate tax burden on family farms and small businesses, Congress enacted section 2032A.[88] Section 2032A is an exception to the general rule that the value of real property is its fair market value based on its highest and best use. The legislative history states:

> [W]hen land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes.[89]

With regard to family farms, Congress sought to subject qualified farms to estate taxation based on their true productive value for farming.[90] The Service has noted that Congress intended section 2032A

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86. *See* JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, *supra* note 1, at 536-37 (explaining that one of the most important factors used in determining fair market value is the highest and best use to which property can be put); *see also* Estate of Sherrod v. Commissioner, 82 T.C. 523, 531 (1984), *rev'd on other grounds*, 774 F.2d 1057 (11th Cir. 1985); Treas. Reg. § 20.2032A-3(a) (1980).

87. H.R. REP. No. 1380, 94th Cong., 2d Sess. 5, 1976 U.S. CODE CONG. & ADMIN. NEWS 3359; JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, *supra* note 1, at 12, 537; Note, *supra* note 44, at 850-57; Note, *supra* note 56, at 640-41.

88. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(a), 90 Stat. 1520 (1976).

89. H.R. REP. No. 1380, 94th Cong., 2d Sess. 21-22, 1976 U.S. CODE CONG. & ADMIN. NEWS 3375-76.

90. Hartley, *Final Regs. Under 2032A: Who, What, and How to Qualify for Special Use Valuation*, 53 J. TAX'N 306, 306 (1980).

to serve two purposes.[91] First, section 2032A is a relief measure to encourage continuation of family farming operations after the death of a farmer, since the fair market value of farmland often does not reflect the land's value based on income produced in the farming operation. Second, the section relieves farm families from liquidity problems on the death of a family member when a lack of liquidity threatens continuation of the farming business.[92]

Commentators state that one of the most complex and important requirements of section 2032A is the material participation requirement.[93] The requirement represents the minimum participation necessary for designation as property qualifying for the special use valuation rules.[94] Moreover, the material participation standard serves as both a condition precedent and a condition subsequent to qualify for special use valuation and avoid recapture of estate tax savings derived from the use of special valuation.[95]

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91. Priv. Ltr. Rul. 8,046,012 (Aug. 8, 1980), IRS Ltr. Rulings Rep. (CCH) No. 195 (Nov. 26, 1980).

92. *See id.*; Priv. Ltr. Rul. 8,041,016 (June 30, 1980), IRS Ltr. Rulings Rep. (CCH) No. 190 (Oct. 22, 1980); *see also* Hartley, *supra* note 90, at 306-07; JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, *supra* note 1, at 536-37 (providing that when land is used for farming or in a closely held business, it is inappropriate to value the land on the basis of its potential "highest and best use" since it is desirable to encourage the continued use of property for farming and other small business purposes).

93. *See* Becker, *Decedent's Rental of Real Estate: Application of Internal Revenue Code Sections 2032A and 6166*, 33 DRAKE L. REV. 371, 374 (1983-1984); Normand, *supra* note 61, at 246; Note, *supra* note 56, at 654; Comment, Estate of Sherrod v. Commissioner: *The "Functionally Related" Requirement of Section 2032A*, 39 TAX LAW. 683, 685-86 (1986).

Generally, § 2032A valuation has several requirements. First, the decedent must have been either a citizen or a resident of the United States at the time of death. I.R.C. § 2032A(a)(1)(A). Second, the property must be located in the United States. *See id.* § 2032A(b)(1). Third, the property must pass to a "qualified heir" of the decedent. *See id.* § 2032A(b)(1), (b)(1)(A)(ii). A "qualified heir" includes ancestors, spouses, lineal descendants, and spouses of any lineal descendants. *See id.* § 2032A(e)(2). Fourth, real or personal property must have been used for a "qualified use," such as use in farming or in a trade or business by the decedent or a member of the decedent's family at the time of the decedent's death, and the real or personal property must represent 50% or more of the adjusted value of the gross estate. *See id.* § 2032A(b)(1)(A). Finally, 25% or more of the adjusted value of the gross estate must consist of real property that during five of the eight years preceding the decedent's death was used for a "qualified use" by the decedent or a member of the decedent's family, and the decedent or a member of the decedent's family must have materially participated in the operation of the farm or business. *Id.* § 2032A(b)(1)(B), (C).

94. *See* Note, *supra* note 44, at 880.

95. *See* Note, *supra* note 56, at 654-55. If during a ten year post-death period there is a disposition of the qualified real property or a cessation of qualified use, an additional estate tax is imposed that recaptures the tax savings. I.R.C. § 2032A(c)(1), (2). Cessation of qualified use occurs if the property is put to a non-trade or business use, a nonfarm use, or if during any eight year period ending after the decedent's death, there were periods in the aggregate of three years or more during which there was no material participation. *Id.* § 2032A(c)(6).

The material participation standard does not focus on how the property was used. Instead, the standard considers the decedent's or family member's level of participation in the farm or business. The primary objective of section 2032A is to permit the continuation of the family farm and small business.[96] In achieving this goal, material participation ensures family involvement in the farming or business operation.[97] Material participation precludes those estates in which land is a mere passive investment from qualifying for the special use valuation.[98]

Section 2032A(e)(6) provides that material participation is determined "in a manner similar to the manner used for purposes of" section 1402(a)(1). However, the phrase "in a manner similar to" may allow for a variation in the definition of material participation. Commentators suggest that the expansive reading given the term in some of the early self-employment cases may not be appropriate for section 2032A.[99] Material participation in the social security context was part of an expansion of the law's coverage,[100] but is used as a limitation under section 2032A.[101]

The regulations under section 2032A provide that material participation is a factual determination,[102] yet they set forth a two-pronged test. The material participation standard is met if either prong is satisfied. In the first prong, full time employment in the farming operation or business will satisfy "material participation."[103] Full time employment involves working thirty-five hours a week or more. However, the regulations provide that for small farms or businesses requiring less than thirty-five work-hours per week, full time employment to the extent necessary to operate the farm or business fully is sufficient to satisfy the material participation requirement.[104]

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96. *See supra* notes 88-92 and accompanying text.

97. *See* Hartley, *supra* note 90, at 307; Comment, *supra* note 93, at 686.

98. *See* Treas. Reg. § 20.2032A-3(a) (1980) (providing that passively collecting rents, salaries, draws, dividends, or other income from a business or engaging in other passive activity is not sufficient for material participation); Priv. Ltr. Rul. 8,149,002 (July 22, 1981), IRS Ltr. Rul. Rep. (CCH) No. 250 (Dec. 16, 1981) (stating that material participation connotes active involvement); Note, *supra* note 56, at 654 n.118.

99. *See* Hartley, *supra* note 90, at 310; Zumbach, *supra* note 61, at A-8.

100. *See supra* notes 62-66 and accompanying text.

101. *See* Hartley, *supra* note 90, at 310; Zumbach, *supra* note 61, at A-8; Note, *supra* note 44, at 873.

102. Treas. Reg. § 20.2032A-3(a) (1980).

103. *Id.* § 20.2032A-3(e)(1).

104. *Id.* § 20.2032A-3(e)(1) (1980); *see also id.* § 20.2032A-3(g), Ex. 7 (1980). A doctor contracted with a professional forester to manage his timber farm located 50 miles away. *Id.* The doctor approved the farm plan, actively participated in management decisions, and inspected

According to the second prong, if the involvement in the farm or business operation is less than full time, it must be pursuant to an arrangement providing for actual participation in production or management. Section 2032A regulations require that the standards prescribed in the regulations promulgated under section 1402(a)(1) be met. As under section 1402 regulations, section 2032A regulations provide for oral or written arrangements. Activities of any agent or employee other than a family member are not considered in the determination.[105]

If the participant is self-employed at the farm or business, income from the operation must constitute earned income for the self-employment tax under section 1401 before material participation exists under section 2032A.[106] Section 2032A regulations provide that payment of the self-employment tax is not conclusive as to the presence of material participation. The regulations thus use the payment of self-employment tax as a litmus test. If no self-employment tax has been paid, a lack of material participation is presumed. Even if the presumption is overcome, all self-employment tax due must be paid.[107]

The regulations set forth several additional factors for determining material participation. While no single factor is dispositive, physical work and participation in management decisions are the principal factors considered. Minimum requirements are regular advice and consultation with the other managing party on the operation of the business.[108] The decedent or family members are not required to make all

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the timber farm twice each year. *Id.* The doctor was deemed to have materially participated rather than passively invested in timber land because his personal involvement amounted to more than managing an investment. *Id.* The Service noted that in this type of operation, there was no need for frequent inspections or consultation. *Id.* A similar situation occurred in Estate of Sherrod v. Commissioner, 774 F.2d 1057 (11th Cir. 1985), *cert. denied*, 107 S. Ct. 66 (1986). The Eleventh Circuit agreed with the Tax Court's conclusion as to material participation. The fact that control and management of decedent's timber farm business did not take a great deal of time did not mean that there was no material participation. *Id.* at 1063.

105. Treas. Reg. § 20.2032A-3(e)(1) (1980).

106. *Id.*

107. *Id.*; Priv. Ltr. Rul. 8,052,011 (Sept. 18, 1980), IRS Ltr. Rulings Rep. (CCH) No. 202 (Jan. 14, 1981). The Service has ruled that the requirement for paying self-employment tax includes only those self-employment taxes that can be assessed at the time of the determination. The requirement does not include self-employment taxes barred by the statute of limitations under § 6501. Rev. Rul. 83-32, 1983-1 C.B. 226; *see also* Priv. Ltr. Rul. 8,207,006 (Oct. 29, 1981), IRS Ltr. Rulings Rep. (CCH) No. 260 (Feb. 24, 1982). If no self-employment tax is due because the threshold for filing has not been met, only a factual determination as to material participation need be made. Priv. Ltr. Rul. 8,046,012 (Aug. 8, 1980), IRS Ltr. Rulings Rep. (CCH) No. 195 (Nov. 26, 1980).

108. Treas. Reg. § 20.2032A-3(e)(2) (1980); *see, e.g.*, Priv. Ltr. Rul. 8,444,016 (July 26, 1984), IRS Ltr. Rulings Rep. (CCH) No. 195 (Nov. 26, 1980).

final management decisions, but they must make a substantial number of the decisions. Also, production activities should be regularly inspected.[109] The regulations set forth the following additional factors: advancing funds and assuming financial responsibility for a substantial portion of operating expenses; furnishing machinery, implements, and livestock for production activities; and maintaining a residence on the premises.[110] Retaining a farm manager does not by itself prevent material participation. However, the decedent or family member must personally materially participate under the terms of the arrangement.[111]

The regulations under section 2032A, therefore, follow the same pattern as the regulations under section 211(a)(1) of the Social Security Act and section 1402(a)(1). The regulations under the self-employment provisions look at the owner's participation in production. In the same way, section 2032A regulations examine direct involvement in the farm or business operation by full-time employment. Both the self-employment regulations and section 2032A regulations consider participation through management and give considerable weight to advising, consulting, and inspecting. Self-employment cases do, however, place more emphasis on the final decisionmaking authority.

B. *Judicial Construction*

Case law under section 2032A places greater weight on regulations than does case law under the self-employment provisions. In *Estate of Coon v. Commissioner*,[112] decedent's farm was leased to an experienced tenant under a sharecrop arrangement. The Tax Court found that petitioner's participation in management decisions was limited to discussing the planned crops with the tenant, telling the tenant where to buy the landlord's share of seed and fertilizer, and consulting with the tenant on such matters as improvements and major repairs. The court observed that these decisions required attention on an infrequent basis.[113] The Tax Court relied on regulations under section 2032A in holding that material participation did not exist because the petitioner had not regularly advised or consulted with the tenant, or participated in a substantial number of final management decisions, and had not inspected production activities.[114]

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109. Treas. Reg. § 20.2032A-3(e)(2) (1980).

110. *Id.*

111. *Id.*; *see also* Priv. Ltr. Rul. 8,444,016 (July 26, 1984), IRS Ltr. Rulings Rep. (CCH) No. 401 (Nov. 7, 1984).

112. 81 T.C. 602 (1983).

113. Estate of Coon v. Commissioner, 81 T.C. 602, 609-08 (1983).

114. *Id.* at 608-11.

The petitioner in *Estate of Coon* had argued that section 2032A regulations were not valid because they imposed a higher standard of activity than did section 1402(a) regulations. The Tax Court refused to decide this question since the court found that the petitioner had not materially participated in the farm operation according to section 1402(a)(1).[115] While referring specifically to the factors of advising, consulting, and inspecting, the Tax Court held that the petitioner had not participated in management of production within the meaning of Treasury Regulation section 1.1402(a)-4(b)(4).[116]

Estate of Coon is important because it demonstrates a different approach to judicial construction under section 2032A than under the self-employment provisions. Under section 2032A, courts impose a stricter hands-on approach in determining material participation. This approach was also used in *Mangels v. United States*.[117] The court gave substantial weight to Treasury Regulation section 20.2032A-3(e) and (g) in holding that no material participation existed under a sharecrop arrangement.[118] The court noted that plaintiff did not live on the farm, performed no physical work, furnished no machinery or implements, and rarely consulted with the tenant or inspected the farm. Plaintiff's exclusive control over certain management decisions relating to marketing and long-term improvements was not enough. The court held that more participation was required for material participation.[119]

The court in *Estate of Coon* stated that the material participation standard imposes a limitation on the availability of special use valuation to the family farm or business.[120] In *Estate of Trueman v. United States*,[121] the Claims Court noted that material participation excluded passive businesses from the benefits of section 2032A. In contrast, material participation in the social security provisions expanded coverage.[122] Courts will nonetheless require more direct involvement in the daily operations of a farm or business for material participation under section 2032A than under the self-employment provisions.

115. *Id.* at 611.
116. *Id.* at 611-12.
117. 632 F. Supp. 1555 (S.D. Iowa 1986).
118. Mangels v. United States, 632 F. Supp. 1555, 1559 (S.D. Iowa 1986). As in *Estate of Coon*, the plaintiff argued that regulations under § 2032A were invalid because they created a standard that was more difficult to satisfy than the standard under § 1402(a). *Id.* at 1559 n.1. The *Mangels* court rejected this argument and relied on Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986). *Martin* involved "qualified use" under § 2032A. However, the court did give substantial weight in its decision to Treas. Reg. § 20.2032A-3. Martin v. Commissioner, 783 F.2d at 84.
119. Mangels v. United States, 632 F. Supp. 1555, 1559 (S.D. Iowa 1986).
120. Estate of Coon v. Commissioner, 81 T.C. 602, 608 (1983).
121. 84-2 U.S.T.C. ¶ 13,590 (Cl. Ct. 1984).
122. *See supra* notes 62-66 and accompanying text.

C. *Active Management*

The need for direct involvement is demonstrated by enactment of the "active management" standard under the Economic Recovery Act of 1981.[123] That Act expanded the coverage of section 2032A for a limited class of heirs.[124] For "eligible qualified heirs," an "active management" standard is substituted for the "material participation" standard. The special rule covers the surviving spouse or a qualified heir who is under the age of twenty-one, a full-time student, or disabled.[125] For this limited class, "active management" will be treated as "material participation."[126] "Active managment" is defined as the "making of the management decisions of a business (other than the daily operating decisions)."[127]

In *Estate of Coon*, the Tax Court recognized that active management was a lesser standard of involvement than material participation.[128] The court said a contrary argument would assume that section 2032A(c)(7)(B) was superfluous.[129] The court stated that under the facts presented, the petitioner may have actively managed the farm, but the court did not decide that issue because the decedent died before the effective date of the active management provisions.[130]

In summary, the active management standard appears to focus on final decisionmaking authority. The extent of participation required for active management coincides with the participation required by

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123. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421, 95 Stat. 306 (1981).
124. I.R.C. § 2032A(b)(5), (c)(7).
125. *Id.* § 2032A(c)(7)(C).
126. *Id.* § 2032A(b)(5)(A), (c)(7)(B).
127. *Id.* § 2032A(e)(12). The legislative history states:

> Active management means the making of business decisions other than the daily operating decisions of a farm or other trade or business. The determination of whether active management occurs is factual, and the requirement can be met even though no self-employment tax is payable under section 1401 by the spouse with respect to income derived from the farm or other trade or business operation. Among the farming activities, various combinations of which constitute active management, are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended. Examples of management decisions are decisions such as what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should undertake.

S. REP. No. 144, 97th Cong., 1st Sess. 134-35, 1981 U.S. CODE. CONG. & ADMIN. NEWS. 235.
128. 81 T.C. 602, 613 (1983).
129. *Id.*
130. *Id.*

case law for material participation under the Social Security Act. By expanding the definition of material participation, courts extended the coverage under the Social Security Act of the benefits of the legislation. Conversely, with regard to special use valuation, Congress expanded the coverage of these benefits through the active management standard. The participation under both provisions appears to be the same. The difference is that with section 2032A, Congress limited the expanded coverage to a certain category of individuals.

D. *Material Participation Under Section 2032A Versus Material Participation Under Section 1402(a) and the Social Security Act*

Material participation under section 2032A may thus differ from the definition under the Social Security Act and section 1402. The key to the difference may be section 2032A(e)(12), which defines active management as the making of a business' management decisions other than the daily operating decisions. This definition implies that material participation must involve daily operating decisions. Material participation under section 2032A therefore involves frequent, direct, and personal involvement with the actual operations of the enterprise. Briefly stated, material participation under section 2032A requires more hands-on involvement.

Since two different standards exist for material participation, one should utilize extreme caution when applying self-employment cases to the area of special use valuation. The remaining question is whether the same caution is appropriate for material participation under the passive activity loss provisions.

V. MATERIAL PARTICIPATION UNDER SECTION 469

Section 469 considers the level of participation to determine whether an activity is passive.[131] In order to materially participate, a taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis.[132] The significant involvement required by section 469 results in a material participation standard higher than that under sections 1402(a) and 2032A.

Legislative history provides that the existence of material participation is determined by reference to all relevant facts and circumstances.[133] The legislative history, however, goes on to state: "This

131. I.R.C. § 469(c)(1).
132. *Id.* § 469(h)(1).
133. S. REP. No. 313, 99th Cong., 2d Sess. 732 (1986).

standard is based on the material participation standards under Code sections 1402(a) (relating to the self-employment tax) and 2032A (relating to valuation of farm property for purposes of the estate tax). However, the standard is modified consistently with the purposes of the passive loss provision."[134]

Therefore, authority for material participation under sections 1402(a) and 2032A may help define the term under section 469. Yet, material participation does not necessarily have the same meaning under section 469 as under sections 1402(a) and 2032A. Many commentators have nevertheless requested the Service to interpret the term consistently with sections 1402(a) and 2032A.

A. *Public Comments*

The agricultural industry has urged the Service to adopt the material participation standard under section 1402(a).[135] The industry believes that sharecrop leases in which the landowner materially participates under section 1402 should not be considered rental activity for purposes of the definition of passive activity under section 469.[136] The agricultural industry also contends that regulations under section 469 should coordinate existing law on material participation in sharecrop leases to the passive loss rules. The industry asserts that the taxpayer's exercise of final decisionmaking authority should constitute material participation.[137] The industry seems to favor the more lenient standard found under the self-employment cases.

The agricultural industry also contends that the existence of professional farm managers should not preclude material participation if the taxpayer is involved in the decisionmaking process. The American Society of Farm Managers and Rural Appraisers had even suggested that language similar to that found in Treasury Regulation section 20.2032A-3(e)(2) should be used in the explanation prepared by the

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134. *Id.*

135. 34 TAX NOTES (TAX ANALYSTS) 550 (Feb. 9, 1987) (discussing a comment submitted by the American Society of Farm Managers and Rural Appraisers); 34 TAX NOTES (TAX ANALYSTS) 324 (Jan. 26, 1987) (discussing a comment submitted by the National Grange).

136. Under I.R.C. § 469(c)(2), "passive activity" includes any rental activity, whether or not the taxpayer materially participates. The position of the American Society of Farm Managers and Rural Appraisers is based on language in the Senate Committee Report providing that with regard to farming, an individual who has self-employment income with respect to the farm under § 1402 will generally be treated as materially participating even though the individual does not perform physical work. *See* S. REP. No. 313, 99th Cong., 2d Sess. 733-34 (1986).

137. In support of its position, the National Grange cites Rev. Rul. 57-58, 1957-1 C.B. 270, which concerned "material participation" under § 1402(a).

Staff of the Joint Committee on Taxation.[138] However, this proposed language was omitted from the Staff's explanation.[139]

The forest industry has also commented on the application of the material participation standard under section 469.[140] The concern is over the low level of activity required of timber farmers compared to other industries. Relying on authority under section 2032A, the forest industry contends that regulations under section 469 should provide that this low level of activity does not preclude material participation.[141] The industry further suggests that the timber owner who uses the services of a forestry professional materially participates as long as the owner retains and exercises decisionmaking power.[142]

The above comments support a qualitative test, under which the importance of the taxpayer's role in the activity would be a critical factor. In contrast, some tax practitioners have argued that a qualitative test would create unacceptable levels of uncertainty and be difficult to apply.[143] These practitioners contend that a quantitative test, based on the taxpayer's amount of time devoted to an activity, would provide objective guidance to taxpayers and could be easier to administer by the Service.[144]

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138. 34 TAX NOTES (TAX ANALYSTS) 550 (Feb. 9, 1987) (discussing a comment submitted by the American Society of Farm Managers and Rural Appraisers); TAX NOTES, Jan. 26, 1987, 324 (discussing a comment submitted by the National Grange). The National Grange cited Priv. Ltr. Rul. 8,444,016 (July 26, 1984), IRS Ltr. Rul. Rep. (CCH) No. 401 (Nov. 7, 1984) as authority for the same position.

139. JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 239-40.

140. 34 TAX NOTES (TAX ANALYSTS) 861 (Mar. 2, 1987) (discussing the response of the Forest Industries Committee on Timber Valuation and Taxation to a request for public comment on the passive activity loss rules).

141. The American Society of Farm Managers and Rural Appraisers relies on Estate of Sherrod v. Commissioner, 82 T.C. 523, 536 (1984), *rev'd on other grounds*, 774 F.2d 1057 (11th Cir. 1985).

142. A proposed example for the regulations, submitted in the industry's comment, involved a dentist owning a timber tract 150 miles from home. The industry would find material participation when a professional forester provides the dentist with a list of management alternatives dealing with various aspects of managing the tract. The industry contends that the material participation is by virtue of making specific management decisions of a meaningful kind necessary to operate the business. The industry states that this conclusion applies irrespective of the distance of the taxpayer's residence from the timber tract and regardless of whether or how frequently the taxpayer visits the property. TAX NOTES, *supra* note 140, at 861 (comments by the Forest Industries Committee on Timber Valuation and Taxation).

143. *Evaul and Lipton Suggest "Quantitative" Approach to Defining Material Participation*, 37 TAX NOTES (TAX ANALYSTS) 1276 (Dec. 21, 1987) (comments submitted to Kenton McDonald, Assistant to the Commissioner of the Internal Revenue Service, by David H. Evaul & Richard M. Lipton).

144. *Id.* The Service has considered a quantitative approach for the upcoming § 469 regulations, whereby the material participation test would be based on threshold levels of time spent

B. *Guidelines for Material Participation Under Section 469*

Prior to promulgation of regulations in this area, legislative history will be extremely important to tax practitioners in formulating a standard for material participation.[145] The Senate Committee Report provides that an individual's involvement in the operation of the business is essential for material participation.[146] The report also provides more specific guidance for the material participation determination.

Material participation is most likely to occur when involvement in an activity is the taxpayer's principal business.[147] A low level of activity, however, does not preclude material participation. The Conference Committee Report states that a taxpayer probably materially participates in an activity by doing everything necessary to conduct the activity, even if the actual amount of work required is low in comparison to other activities.[148] For example, the owner of a timber tract might materially participate in the timber operation despite the low level of participation required during the year.

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in an activity. In public comments made by Mr. William F. Nelson, Chief Counsel for the Service, the proposed quantitative approach would require a minimum of 500 hours for clear material participation, less than 100 hours would not satisfy the material participation test; and participation between the 100 and 500 hour range would require a facts and circumstance analysis. Skadden, *Nelson Comments on Pending Passive Loss Regs*, 37 TAX NOTES (TAX ANALYSTS 1080-81 (Dec. 14, 1987) (comments made by William F. Nelson, Chief Counsel for the Internal Revenue Service, before the AICPA Tax Division).

Some tax practitioners have suggested that the time levels proposed by the Service are too low and more involvement should be required for material participation. TAX NOTES, *supra* note 143, at 1276-77. However, other practitioners totally reject the quantitative approach as impractical and unfair and support a qualitative test. *Gunnar Questions "Quantitative" Approach to Material Participation*, 38 TAX NOTES (TAX ANALYSTS) 192-93 (Jan. 11, 1988) (comments submitted to Kenton McDonald, Assistant to the Commissioner of the Internal Revenue Service, by Peter M. Gunnar).

145. The Service has indicated that the regulations on material participation under § 469 should be issued in the near future. Skadden, *supra* note 144, at 1080 (comments made by William F. Nelson, Chief Counsel for the Internal Revenue Service, before the AICPA Tax Division).

146. S. REP. No. 313, 99th Cong., 2d Sess. 732 (1986).

147. *Id.* at 732-33. When an activity is not an individual's principal business, it is less likely that the individual has materially participated. Nevertheless, whether an activity is an individual's principal business is not conclusive in determining material participation. *Id.*

In a colloquy between Senators Hawkins and Packwood, Hawkins noted that a taxpayer working full time elsewhere as an employee or in a professional service business could materially participate in the operation of a citrus grove if the taxpayer actively participated in management decisions concerning the citrus grove. 132 CONG. REC. S13954 (daily ed. Sept. 27, 1986) (remarks of Senator Hawkins). Many tax authorities question the utility of statements such as the one made by Senator Hawkins. 33 TAX NOTES (TAX ANALYSTS) 128 (Oct. 13, 1986).

148. H.R. REP. No. 841, 99th Cong., 2d Sess. II-148 (1986).

The Senate Committee Report also discusses the taxpayer's presence at the site of the principal operations of the activity.[149] Self-employment cases have found material participation even when the taxpayer lived a substantial distance from the farm.[150] These cases will not, however, provide authority for material participation under section 469.

The knowledge or experience of the taxpayer is also a factor in determination of material participation under section 469.[151] Formal and nominal participation in management, without genuine exercise of independent discretion and judgment, does not constitute material participation.[152] Taxpayer knowledge and experience, however, indicates independence in making business decisions. The courts will probably not limit their examination to the knowledge and experience of only the taxpayer. Cases examining material participation under the self-employment provisions considered the knowledge and experience of all parties.[153] For example, the knowledge and experience of a tenant under a sharecrop lease could indicate whether the landlord is materially participating in the arrangement.

Even if the taxpayer does possess sufficient knowledge and experience, no material participation exists if the taxpayer simply approves a paid advisor's management decisions.[154] Little weight will be given to management decisions that are illusory, guided by an expert without the exercise of independent discretion and judgment by the taxpayer, or unimportant to the business.[155] In such a situation, the taxpayer's role would not be substantial because the decisions could have been made without taxpayer involvement.[156]

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149. S. REP. No. 313, 99th Cong., 2d Sess. 733 (1986). The Senate Committee Report states:

> For example, in the case of an employee or professional who invests in a horse breeding activity, if the taxpayer lives hundreds of miles from the site of the activity, and does not often visit the site, such taxpayer is unlikely to have materially participated in the activity. By contrast, an individual who raises horses on land that includes, or is close to, his primary residence, is more likely to have materially participated.

Id.

Distance is not conclusive. The Senate Committee Report does recognize that in some circumstances, an individual may materially participate in an activity without being present at the activity's principal place of business. *Id.*

150. *See supra* notes 73-74 and accompanying text.

151. S. REP. No. 313, 99th Cong., 2d Sess. 734 (1986).

152. *Id.*

153. *See supra* notes 75-78 and accompanying text.

154. S. REP. No. 313, 99th Cong., 2d Sess. 734 (1986).

155. *Id.*

156. *Id.*

Taxpayer use of employees or contract services to perform daily business functions does not prevent material participation.[157] Agents' activities, however, are not attributed to the taxpayer.[158] The taxpayer must still personally perform enough services to establish material participation.[159]

The Senate Committee Report provides that even an intermittent role in management, while relevant, does not establish material participation absent regular, continuous, and substantial involvement in operations.[160] The owner of an interest in an activity usually has some right to make management decisions.[161] However, the passive loss provisions were intended to limit the tax preferences received by passive investors. Accordingly, the Senate Committee Report warns against undue reliance on participation in management. A general management role, without more involvement, may fall short of the participation level that section 469 requires.[162]

Commentators suggest that the material participation standard under section 469 requires such a high degree of participation that it is almost impossible to satisfy the test except in connection with a principal occupation.[163] The high standard could create a situation in which an individual involved in a number of activities would fail to materially participate in any of the activities. Such an occurrence could

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157. *Id.* at 735.

158. *Id.*

159. *Id.*

160. *Id.* at 734-35.

161. *Id.* at 734.

162. *Id.* The Conference Committee Report clarifies material participation in agricultural activity. Decisionmaking that is bona fide and undertaken on a regular, continuous, and substantial basis may be relevant to the material participation determination. The Conference Committee Report provides that the types of decisionmaking that may be relevant include, without being limited to, decisionmaking regarding (1) rotating, selecting, and pricing crops; (2) incurring expenses of embryo transplant or breeding; (3) buying, selling, and leasing capital items, such as cropland, animals, machinery, and equipment; (4) breeding and mating; and (5) selecting herd or crop managers who then act on behalf of the taxpayer, rather than as paid advisors directing the conduct of the taxpayer. H.R. REP. No. 841, 99th Cong., 2d Sess. II-148 (1986); *see also* 132 CONG. REC. S8244-46 (daily ed. June 24, 1986) (remarks of Senator Hatfield) (discussing the meaning of material participation in the context of condominium hotel unit owners); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 239-42.

163. Lipton, *supra* note 4, at 809; *see also* 35 TAX NOTES (TAX ANALYSTS) 1139 (June 15, 1987). Commentators argue that the statutory language and legislative history of § 469 take a quantitative approach to the material participation concept. The focus of the material participation standard is on the amount of time that the taxpayer devotes to the activity. *See* Lipton, *What We Know and Don't Know About PALs*, 37 TAX NOTES (TAX ANALYSTS) 429, 432-33 (Oct. 26, 1987).

lead to avoidance of the passive activity loss rules, since without material participation, a profitable activity could produce passive income that could be used to offset passive losses.[164]

C. *Material Participation Under Section 469 Versus Material Participation Under Sections 1402(a) and 2032A*

Although the material participation standard under section 469 is based on material participation standards under sections 1402(a) and

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164. Lipton gives the following example:

> For example, suppose that an individual owns and manages three apartment complexes, runs the maintenance company for each, also is involved in the development and construction of a fourth apartment building, and has investments as a general partner in a chain of grocery stores. The individual would be able to claim that he does not materially participate in any one single business, since he does not work in any one of them on a regular, continuous and substantial basis. Thus, if the apartment building generated losses, the taxpayer would be able to utilize such losses to offset the income from his other businesses in which he did not materially participate.

Lipton, *supra* note 4, at 809-10.

Lipton suggests that material participation may even prove to be a valuable planning tool. A taxpayer may want to decrease his level of participation intentionally to create passive income. *Id.* at 813.

The Conference Committee Report addressed this problem with the "line of business" test. The test provides that an individual who works full time in a line of business consisting of one or more business activities will be treated as materially participating in each activity even if the individual's role is in management rather than operations. *See* H.R. REP. No. 841, 99th Cong., 2d Sess. II-147-48 (1986). The purpose of the "line of business" test is to make certain that individuals cannot avoid the passive activity loss rules by being involved in so many activities that they do not materially participate in any one of them. *See* Lipton, *supra* note 4, at 809.

In contrast to the Conference Committee Report's "line of business" test, the Explanation of the Joint Committee on Taxation states:

> The fact that an individual works full time in a line of business consisting of one or more business activities does not determine his material participation in a particular activity, although his work may rise to the level of material participation with respect to one or more of the activities. An individual's material participation in any activitiy is determined on the basis of his regular, continuous and substantial involvement in the operations of the activity. His involvement in the operations of other activities is not determinative.

JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 240.

On November, 25, 1986, the ABA Section of Taxation's Special Task Force on Passive Activity Losses submitted a letter to David Brockway, the Joint Committee on Taxation Chief of Staff, in response to request for comments on the passive loss provisions. The ABA voiced its concern over the "line of business" test and recommended the test be limited to a relief provision to be applied as set forth in the regulations and only available upon election by the taxpayer and subject to approval by the Service. 33 TAX NOTES (TAX ANALYSTS) 969 (Dec. 8, 1986). *See also* 35 TAX NOTES (TAX ANALYSTS) 1139-40 (June 15, 1987); 37 TAX NOTES (TAX ANALYSTS) 1276-77 (Dec. 21, 1987).

2032A, legislative history provides that precedents under sections 1402(a) and 2032A are not intended to be controlling with regard to the passive loss rules.[165] The Senate Committee Report states:

> For example, whether or not, under existing authorities interpreting sections 1402(a) and 2032A, it could be argued that the material participation requirement (for purposes of those sections) is in certain circumstances satisfied by periodic consultation with respect to general management decisions, the standard under this provision is not satisfied thereby in the absence of regular, continuous, and substantial involvement in operations.[166]

The focus of the material participation standard under section 469 is on the taxpayer's role in actual operations.[167] The material participation standard under section 469 is therefore much stricter than the standards under sections 1402(a) and 2032A. One commentator stated that the level of activity required for material participation is so high that it requires full time involvement in the activity.[168]

A high material participation standard is in accord with the purpose of the passive activity loss provisions. Through the passive activity loss rules, Congress intended to curb abusive tax shelters while preserving tax preferences for those taxpayers to whom the preferences were directed.[169] The benefit of the tax preferences is directed primarily toward taxpayers with a substantial and bona fide involvement in preferred activities.[170] The material participation standard ensures this type of preferred involvement and bars use of passive losses to reduce positive income from other sources. The benefit of the loss is not available with regard to positive income until the material participation standard is met.[171]

The use of material participation as a limitation was also seen under section 2032A. In the section 2032A context, commentators suggested that the term should be narrowly construed.[172] Case law under section 2032A has noted the role of material participation as a limitation. These decisions have placed considerable emphasis on the

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165. S. REP. No. 313, 99th Cong., 2d Sess. 732 (1986).

166. *Id.*

167. *Id.*

168. *See* Lipton, *supra* note 4, at 803; *see also* 35 TAX NOTES (TAX ANALYSTS) 1139 (June 15, 1987); 37 TAX NOTES (TAX ANALYSTS) 429, 432-33 (Oct. 26, 1987).

169. *See supra* notes 28-30 and accompanying text.

170. *See supra* notes 32-33 and accompanying text.

171. *See supra* note 38-40 and accompanying text.

172. *See supra* note 99 and accompanying text.

regulations under section 2032A.[173] In contrast, the courts give the term material participation an expansive reading in the context of the self-employment provisions where the term is part of an expansion of the coverage of social security benefits.[174] The function of material participation as a limitation under section 469, and the difference in judicial construction under section 2032A and the self-employment provisions, suggest that courts will probably strictly construe the term material participation under section 469. Congress was quite clear in its declaration of war on tax shelters. The courts can be expected to assist in this effort through strict construction of material participation.

Notably, the case law under the self-employment provisions will afford little guidance or authority for material participation under section 469. Pursuant to the *Henderson* line of cases, the Fifth Circuit Court of Appeals indicated that financial contributions alone may sometimes constitute material participation.[175] This line of authority clearly will not be valid under section 469. One of the functions of material participation under section 469 is to identify passive investors seeking only a return on capital in order to apply the passive activity loss restrictions to these taxpayers.[176]

Legislative history indicates a clear distinction between the at-risk rules of section 465 and the passive activity loss rules of section 469. The at-risk standards are not a sufficient basis for determining whether losses from an activity should be deducted against other sources of income.[177] Congress' goal was to confine the availability of tax preferences to those taxpayers who were active participants in substantial businesses.[178] Congress noted that this goal was best accomplished by examining the taxpayer's participation in the activity rather than the taxpayer's financial stake.[179] Consequently, an investor's placing capital at risk to receive a return on investment is totally irrelevant as to the material participation standard under section 469.

Judicial authority under the self-employment provisions is also suspect because of the emphasis placed on the landlord's final decisionmaking authority. Although section 1402 regulations and the social security

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173. *See supra* notes 112-22 and accompanying text.

174. *See supra* notes 62-66 and accompanying text.

175. *See supra* notes 67-72 and accompanying text.

176. *See supra* note 35-37 and accompanying text.

177. S. REP. No. 313, 99th Cong., 2d Sess., 717 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 213.

178. S. REP. No. 313, 99th Cong., 2d Sess., 717 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 213.

179. S. REP. No. 313, 99th Cong., 2d Sess., 717 (1986); JOINT COMM., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 7, at 213.

regulations place considerable weight on advising, consulting, and inspecting, the court decisions place more emphasis on the landlord's final decisionmaking authority.[180] A general management role without more involvement may fall short of the involvement required for material participation under section 469.[181] The standard under both sections 2032A and 469 requires more direct taxpayer involvement in the operations of the activity.

The degree of involvement required for material participation under sections 2032A and 469 is more clearly demonstrated by the analogous roles of "active management" under section 2032A and "active participation" under section 469. Under section 2032A, the active management standard is a lower standard used to extend the benefits of section 2032A to a certain class of heirs.[182] Under section 469, the active participation standard is designed to be less stringent than the material participation standard, to facilitate availability of the relief afforded under section 469(i) with regard to renting real estate.[183] Under both the active management and the active participation standards, the taxpayer's involvement in operations is not required as long as the taxpayer participates in general management.[184] These standards indicate that the material participation standards under both sections 2032A and 469 require a higher degree of involvement in the activity's operations.

Possibly, the courts will use the involvement required under section 2032A regulations as the bare minimum involvement that will pass muster under section 469. But the section 469 material participation standard will probably require more involvement. Section 2032A regulations set forth a two-pronged test for material participation. One prong concerns full time employment of thirty-five hours per week, while the other prong involves less than full time employment. A taxpayer with less than full time employment may meet the second prong through involvement in production or management.[185] Section 2032A regulations require the taxpayer to be involved in actual operations. The extent of involvement under the second prong of the test, however, does not seem as great as that required by section 469.

The material participation standard under section 469 more closely resembles the first prong of the test in the section 2032A regulations.

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180. *See supra* notes 79-84 and accompanying text.
181. S. REP. No. 313, 99th Cong., 2d Sess. 734-35 (1986).
182. *See supra* note 128-29 and accompanying text.
183. *See supra* note 26-27 and accompanying text.
184. *See supra* notes 27, 127 and accompanying text.
185. *See supra* notes 102-11 and accompanying text.

The similarity is seen in the emphasis that section 469's legislative history places on the activity constituting the taxpayer's principal business. Legislative history reveals that a taxpayer is most likely to have materially participated in an activity if involvement is the taxpayer's principal business.[186] The similarity is also seen in the clarifying comments in the Conference Committee Report. Even with a low level of activity, a taxpayer is likely to materially participate under section 469 by doing everything required to conduct the activity.[187] Analogously, regulations under section 2032A provide that for small farms or businesses requiring less than thirty-five hours a week, full time employment to the extent necessary to operate the farm or business fully is sufficient to satisfy the material participation requirement.[188]

In contrast, the second prong of the test under the section 2032A regulations emphasizes periodic advising, consulting, and inspecting. The regulations require that only a substantial number of final management decisions be made by the party in question.[189] A more limited type of involvement in operations should therefore suffice for the second prong of the test.[190] This rationale is confirmed by the chairman of the ABA Section of Taxation's Special Task Force on Passive Losses, who states: "[T]he material participation requirement is set at such a high degree of participation — regular, continuous, and substantial — that it is almost impossible for anyone to satisfy this test except in connection with his principal occupation."[191]

VI. CONCLUSION

The material participation standard spearheads the congressional attack on tax shelters. The passive activity loss provisions emphasize

186. *See supra* note 147 and accompanying text.

187. *See supra* note 148 and accompanying text.

188. *See supra* note 104 and accompanying text.

189. Treas. Reg. § 20.2032A-3(e) (1980). The regulations also provide that advancing funds and supplying machinery and implements will be factors in the material participation determination under § 2032A. However, the legislative history of § 469 provides that the taxpayer's financial stake in the activity is totally irrelevant for the material participation determination. *See supra* notes 177-79 and accompanying text.

190. The regulations under § 2032A give an example of a lawyer who owned a farm 15 miles from home. The lawyer supplied certain capital needs, approved a crop plan and certain expenditures, consulted with the tenant, made inspections, and participated in certain general management decisions. This involvement constituted material participation under § 2032A. Treas. Reg. § 20.2032A-3(g), Ex. (4). On the other hand, an example in the legislative history under § 469 provides that an individual who works full time in a professional service business, such as law, accounting, or medicine, is unlikely to have materially participated in a business involving the operation of an orange grove. S. REP. No. 313, 99th Cong., 2d Sess. 732-33 (1986); *contra* 132 CONG. REC. S13594 (daily ed. Sept. 27, 1986) (remarks of Senator Hawkins).

191. *Lipton*, *supra* note 4, at 809.

the level of participation in order to determine whether an interest is held as an investment subject to the passive activity loss restrictions. Although the standard has been used in other areas of the law, the authority may be of little value in construing the material participation standard for purposes of section 469.

Legislative history under section 469 indicates that the material participation test is to be a rigorous one. The objective of the passive activity loss provisions is to restrict the benefit of tax preferences to those taxpayers who are substantially involved in the actual operations of those activities for which the preferences were intended. To this end, the material participation standard under the passive activity loss provisions will require a higher level of participation than that required under either the special use valuation rules or the self-employment provisions. In effect, the activity required for the passive activity loss provisions will have to be a principal endeavor of the taxpayer.