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LLCs and the Passive Loss Rules in Flux, Part I

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In this article, we begin a review of limited partnerships (LPs) and limited liability companies (LLCs) under the passive loss rules[1] of the Internal Revenue Code.

The passive loss rules and other provisions of the Tax Reform Act of 1986[2] require the typical tax shelter investor to pay tax currently on his positive income from his business activities, salary, and investment income (e.g., dividends and interest), and generally limits his ability to use losses and credits from "passive activities" other than against income from passive activities until disposition of the property comprising the passive activity. The effective result of the rules is to reverse a key return element from a tax shelter—in effect, the tax shelter investor must first report and pay tax on his salary and investment income and defer the benefit of the losses from the tax shelter until the investment generates income or upon disposition of the property.

The rules generally provide that deductions and credits from passive trade or business activities are limited to the income and tax attributable to all of a taxpayer's passive activities, and cannot be deducted against other income, such as salary, interest, dividends, and active business income. Passive activity losses in excess of passive activity income are suspended and carried forward indefinitely, to be applied against passive activity income in subsequent taxable years.

The term passive activity is defined as the conduct of any trade or business in which the taxpayer does not materially participate. A taxpayer's suspended losses are allocated to each passive activity for carryforward purposes. The allocation is required because the rules allow the deduction of suspended losses upon a fully taxable disposition of a passive activity. Carrybacks are not allowed.

LLCs, LPs and the Rules

Section 469(h)(2) and Reg. §1.469-5T(e) establish a presumption that an individual will not be treated as having "materially participated" in any trade or business undertaken by a limited partnership in which the individual owns an interest as a limited partner. Section 469 and the regulations thereunder do not include any direct guidance on whether an LLC member should be treated as a limited partner. The issue is especially important today where LLCs are the prevalent investment vehicle, particularly among investors in real estate.

The analysis of whether a taxpayer's losses from an LLC will be subject to the rules turns on whether the taxpayer has derived the applicable losses from a passive activity. If not, the taxpayer is free to use these losses to offset income from other sources, provided that such losses are not subject to limitation beyond §469 (e.g., at risk rules of §465).

Material Participation

Reg §1:469-5T(a) ("1988 Regulations")[3] contains seven alternative tests for satisfying the material participation standard. The tests are exclusive (i.e., at least one of the seven tests must be satisfied in order for material participation to exist).[4] The rules can be used by the IRS against a taxpayer or affirmatively by a taxpayer to better his tax position. For example, taxpayer might try to show that (1) he did not materially participate in a trade or business generating income so that the activity would be a passive activity with respect to him, and his income from the activity would constitute passive income against which his passive losses from any source could be deducted, or (2) he materially participated in a trade or business generating losses so that the activity would not be a passive activity with respect to him, and his losses from the activity would not be subject to deferral under the passive loss rules.

A taxpayer will be treated as materially participating in a trade or business activity if (and only if):

1) The 500 hours test. The taxpayer "participates" in the activity for more than 500 hours during the year. Some actions of an individual do not constitute "participation" for purposes of applying the material participation tests.[5] Work performed by a direct or indirect individual owner (other than an individual who owns his interest only through a C corporation) is taken into account regardless of the capacity in which the work is performed (for example, as a partner, LLC member, officer of a corporation, employee, or independent contractor).[6]

Special rules apply in determining a taxpayer's participation in an activity:

a) Investor activities. Unless the individual is directly involved in the day-to-day management or operations of the activity, work performed in his capacity as an investor is ignored (for example, reviewing financial statements or other operational reports; preparing any financial or operational analysis for the individual's own use; and monitoring the finances or operations of the activity in a non-managerial capacity).[7]

b) Noncustomary owner services. Work in connection with an activity is ignored if (1) one of the principal reasons the work is performed is to obtain material participation status to avoid the passive loss disallowance rules and (2) the work is not customarily performed by an owner or this type of activity.[8]

This rule would apply, for example, where a trade or business activity, such as operating a professional football team, generates losses for the year and an investor acts as a part-time receptionist in order to have spent enough time in the activity to achieve material participation for the year so that the losses are not passive losses.[9]

c) Spousal participation. If an individual is married (and is not legally separated) at year end, regardless of whether a joint return is filed for the year, each spouse's participation in an activity during a year is aggregated with that of the other spouse for purposes of determining material participation and applying the other provisions of the passive loss rules.[10] The aggregation of spousal participation in an activity occurs regardless of whether both spouses own interests in the activity or whether either spouse materially participated in the activity without regard to the other spouse's participation for the year.

2) Substantially all participation test. If an individual's participation in the activity for the year constitutes substantially all of the participation of all individuals (whether or not owners) in the activity for the year, regardless of the time he spent participating in the activity, there is material participation.[11]

3) **The 100 hours-most participation test.** The individual participates in the activity for more than 100 hours during the year, and that individual's participation in the activity for the year is not less than the participation in the activity of any other individual (whether or not an owner) for the year.[12]

If the taxpayer's participation is substantially all the participation in that activity, the income or loss will be treated as nonpassive. The hours of an employee or a non-owner could cause the taxpayer to fail this test. There are no quantifying hours with this standard and the term "substantially" is not defined, but the following examples illustrate this standard.

Example 1. The taxpayer (T) runs an appliance repair service out of his home and has no employees. T has a W-2 wage job during the week, but works two days a month in the appliance business. Although the time spent in the appliance business does not exceed 500 hours, all the work performed in that activity is performed by the taxpayer since there are no employees. If a taxpayer participates in an activity for more than 100 hours, but not more than 500 hours, and no other individual participates more than the taxpayer (including any employee of the activity), income or losses from the activity would be treated as nonpassive.

Example 2. Assume the same facts as Example 1. In addition, T has an employee who makes deliveries one day a month. The time spent in the activity is more than 100 hours and does not exceed 500 hours. If T spends more time than the employee, the activity would be treated as nonpassive.

Example 3. Assume the same facts as above except that the employee works every Saturday making basic repairs. T's participation would remain more than 100 hours and not more than 500 hours. However, since T's participation does not exceed that of the employee, the activity would be treated as passive unless one of the other tests for material participation is met.

4) Significant participation test. The activity is a "significant participation activity" for the year (defined as a "trade or business activity in which the taxpayer participates for more than 100 hours during the year if he otherwise does not materially participate in the activity during the year") and his total participation in all of his significant participation activities (regardless of whether the activities are related to one another) for the year exceeds 500 hours.[13]

For example, assume that an individual participates for 200 hours in each of four trade or business activities in which he otherwise does not materially participate during the year under any of the other alternative tests. Under the significant participation test, he is deemed to materially participate in each activity for the year and none of the significant participation activities would be passive activities for the year.

As indicated above, the number of hours spent in one or more activity is a critical fact in the great majority of cases where material participation is at issue. With 100 hours or less, the taxpayer is not a material participant (although a taxpayer will be glad to lose this status if the activity is profitable and therefore offsettable against passive losses). With more than 500 hours, the taxpayer is deemed to be materially participating. With between 100 and 500 hours, the taxpayer is deemed to not be materially participating unless either (i) the taxpayer is materially participating under some other provision, such as the facts and circumstances test, or (ii) the taxpayer spends sufficient time on other significant participation passive activities so that he is deemed to be materially participating in the activity in question.

5) Longstanding participation (five-year) test. An individual does not materially participate under the other six alternative material participation tests but materially participated in the activity under any of those tests for any five years (whether or nor consecutive) out of the 10 years immediately preceding the taxable year in question.[14] This rule attempts to address efforts to plan a taxpayer's material participation too closely to each year's expected profit/loss results by participating in an activity during the start-up phase but then avoiding involvement as soon as the activity becomes profitable.

6) Personal service activity (three-year) test. If the activity is a "personal service activity" and the individual materially participated in the activity for any three years (whether or not consecutive) preceding the year in question, the activity is not a passive activity.[15] A "personal service activity" is defined as an activity that involves the performance of personal services in (1) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or (2) any other trade or business in which capital is not a material income producing factor.[16]

7) Facts and circumstances test. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.[17] Specifically, the 1988 Regulations provide that in order for the facts and circumstances test to apply, the individual must participate in the activity for more than 100 hours during the year, with the individual's participation in management activities (as contrasted with participation in operations) not being taken into account unless (i) no other person receives compensation for management of the activity (i.e., there is no paid manager) and (ii) no person's participation in management of the activity exceeds that of the taxpayer for the year.

In the next article, application of the material participation rules in the LLC context will be examined.

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Endnotes:

1. I.R.C. §469.

2. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

3. T.D. 8175, 53 Fed. Reg. 5,686 (1988).

4. Reg. §1.469-5T(a).

5. Reg. §1.469-5T(f).

6. Reg. §1.469-5T(f)(1). The casual or passive investor often is a professional man, such as a doctor or lawyer. In such a case, the doctor or lawyer's predominant activity is his profession, but, he usually invests in some business activities on the side. By requiring 500 hours of participation for all significant participation passive activities considered together, the 1988 Regulations make it difficult for the doctor or lawyer to shelter his positive income from his profession with losses form his outside business activities. Five hundred hours work is material, being approximately 10 hours a week for a full year, or, approximately 12 weeks of full-time work.

7. Reg. §1.469-5T(f)(2)(ii).

8. Reg. §1.469-5T(f)(2)(i).

9. See, Reg. §1.469-5T(j), Ex. 7.

10. Reg. §1.469-5T(f)(3).

11. Reg. §1.469-5T(a)(2).

12. Reg. §1.469-5T(a)(3).

13. Reg. §§1.469-5T(c) and 1.469-5T(a).

14. Reg. §1.469-5T(a)(5).

15. Reg. §1.469-5T(a)(6).

16. Reg. §1.469-5T(d).

17. Reg. §1.469-5T(a)(7).