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Hi, Robin. Here is your e-newsletter for July 26, 2011.

Court Decisions Make It Easier to Deduct LLC Losses

Great News for Owners of LLCs that Generate Losses

What happens if you're the owner of a limited liability company (LLC) that generates tax losses, and you don't spend a lot of time in the activities of the business? The losses might be classified as *passive*, and your ability to currently deduct them might be severely restricted by the passive activity loss (PAL) rules.

Thankfully, some recent court decisions make it much easier for LLC owners to escape the PAL rules and thereby deduct LLC losses from non-rental activities in the year they are incurred. In a bad economy, being able to currently deduct tax-saving losses is a big deal because losses are common and cash is tight. So these court decisions are good news for LLC owners.

LLC Basics

Using an LLC to own and operate a business shields your personal assets from most business-related liabilities. This liability protection advantage is similar to what you would get with a corporation. However, the tax rules for LLCs are more flexible and often more beneficial than the rules for corporations.

- If you have an LLC with several owners, it's called a multi-member LLC, and will generally be taxed under the partnership rules. If so, your share of the LLC's income, deductions, and tax credits are reported on a Schedule K-1 delivered to you by the LLC as part of its annual tax filing obligations. The LLC tax items are then reported on your tax return.
- If you're the sole owner of an LLC, it's called a single-member LLC (SMLLC), and its existence is generally ignored for tax purposes. The SMLLC's tax items are reported directly on your tax return.

Passive Activity Loss (PAL) Basics

The PAL rules state that passive losses from a business activity can generally be used only to offset passive income from other passive activities. Passive losses in excess of your passive income for the year are suspended and carried forward to future years. You can deduct them in future years when and if you have passive income or when and if you sell or otherwise dispose of the activity that generated the suspended losses. *The problem:* Many taxpayers have little or no passive income for years at a time, so their passive losses can remain suspended for years.

Thankfully, a loss-generating activity is exempt from the PAL rules if you *materially participate* in it--because meeting the material participation standard makes it non-passive. That means you can deduct losses from the activity in the year they are incurred (assuming no other tax-law provision prevents you from doing so).

IRS regulations state you can generally meet the material participation standard for an activity by passing any of the following seven tests.

> ***1. Substantially-All Test:*** This test is passed if the taxpayer's participation (time spent) in the activity during the year constitutes substantially all the participation by all individuals (including those who are not owners of interests in the activity) during that year. So if you basically do all the work in an activity, you'll pass this test even if doing the work doesn't actually take much time.
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> ***2. More-than-100-Hours Test:*** This test is passed if the taxpayer participates in the activity for more than 100 hours during the year, and no other individual participates more than the taxpayer during that year. So this test too can be passed without spending a whole lot of time.
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> ***3. Facts and Circumstances Test:*** This test is passed if consideration of relevant facts and circumstances dictate that the taxpayer materially participated in the activity on a regular, continuous, and substantial basis.
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> ***4. Significant Participation Activity (SPA) Test:*** This test is passed if the activity is a SPA in which the taxpayer participates for more than 100 hours during the year, and the taxpayer's total participation in all SPAs during the year exceeds 500 hours.
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> ***5. More-than-500-Hours Test:*** This test is passed if the taxpayer participates in the activity for more than 500 hours during the year. The problem is, 500 hours is a lot of time, and the LLC or SMLLC activity may not require that much.
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> ***6. Prior-Year Material Participation Test:*** This test is passed for the year if the taxpayer materially participated in the activity for any five of the ten immediately preceding years. Obviously, this test cannot be passed for a new or newish activity.
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> ***7. Personal Service Activity Test:*** This test is passed for the year if the activity is a personal service activity, and the taxpayer materially participated in the activity for any three preceding years. Obviously, this test cannot be passed if the LLC or SMLLC activity doesn't involve the delivery of personal services.

Key Point: The first two tests are usually the easiest to pass. The last three are often the hardest to pass.

What Is the IRS Position?

For years, the IRS has claimed that LLC owners must be treated as limited partners for purposes of the PAL rules, since both limited partners and LLC owners have limited liability. Unfortunately, limited partners can meet the material participation standard for an activity only by passing one or more of the last three tests listed earlier (the more-than-500-hours test, the prior-year material participation test, and the personal service activity test). As stated earlier, these three tests are usually the hardest to pass.

What Have the Courts Ruled?

In 2009 and 2010, four court decisions on how the PAL rules should be applied to LLC owners came out in favor of taxpayers. Three of the decisions were from the U.S. Tax Court (they are especially significant because they hold sway over the entire nation).

In effect, all four decisions say LLC owners should be treated the same as general partners when taking the material participation tests. General partners can take all seven of the tests explained earlier, including the two easiest ones. If any of the tests are passed for the loss-generating activity in question for the year in question, the activity is exempt from the PAL rules for that year, and the losses from the activity can be deducted in that year (assuming no other tax-law provision prevents this taxpayer-friendly outcome).

The common thread in the court decisions is the fact that state laws allow LLC owners to be heavily involved in LLC activities. In contrast, when a limited partner becomes too involved in a partnership's affairs, his limited partner status may be lost under applicable state partnership laws. According to the courts, this important distinction makes it impossible to conclude that LLC interests are equivalent to limited partner interests for PAL purposes. (*Lee Newell*, 132 TC Memo 2010-23; *Paul Garnett*, 132 TC No. 19; *James Thompson*, Court of Federal Claims; and *Sean Hegarty*, Tax Court Summary Opinion 2009-153)

Conclusion: The important factor to understand here is that an LLC owner has only to pass one of the two easy tests explained earlier to meet the material participation standard for an activity and thereby make that activity exempt from the PAL rules. This is great news for owners of LLCs that throw off losses, such as fishing boat charter and air charter operations and start-up businesses. That said, don't get carried away. If you have a loss-generating LLC or SMLLC, consult with your tax professional to make sure you understand all the other tax loss limitations that can potentially come into play.

Note: If your loss-generating LLC or SMLLC is a rental operation, this article is not relevant. With some very specific exceptions, rental losses generally must be treated as passive losses by definition.

Feedback

Is this item worthy of implementation?	**Yes**	**No**	**Maybe**
Is this item worth sharing with other associates?	**Yes**	**No**	**Maybe**
Did this item present value to you and your business?	**Yes**	**No**	**Maybe**

Comments:

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