

**Abstract:** The IRS has treated owners of LLCs and LLPs as *limited* partners for purposes of the passive activity loss rules. This could be a tax negative. As this article explains, however, LLC and LLP owners can now be treated as *general* partners, which means they can meet any one of seven “material participation” tests to avoid passive treatment.

## **LLC and LLP owners should befriend the PAL rules**

The limited liability company (LLC) and limited liability partnership (LLP) business structures have their advantages. But, in years past, the IRS treated LLC and LLP owners as *limited* partners for purposes of the passive activity loss (PAL) rules. This could be a tax negative. Fortunately, LLC and LLP owners can now be treated as *general* partners, which means they can meet any one of seven “material participation” tests to avoid passive treatment.

### **Rules to own by**

The PAL rules prohibit taxpayers from offsetting losses from passive business activities (such as limited partnerships or rental properties) against nonpassive income (such as wages, interest, dividends and capital gains). Disallowed (that is, suspended) losses may be carried forward to future years and deducted from passive income or claimed when the passive business interest is disposed in a taxable transaction.

There are two types of passive activities: 1) trade or business activities in which you *don't* materially participate during the year, and 2) rental activities, even if you do materially participate (unless you qualify as a “real estate professional”).

### **The 7 tests**

Material participation in this context means participation on a “regular, continuous and substantial” basis. Unless you’re a limited partner, you’re deemed to materially participate in a business activity if you meet just *one* of seven tests:

1. You participate in the activity more than 500 hours during the year.
2. Your participation constitutes substantially all participation for the year by anyone, including nonowners.
3. You participate more than 100 hours and as much or more than any other person.
4. The activity is a “significant participation activity” — that is, you participate more than 100 hours but less than one or more other people, yet your participation in all significant participation activities for the year totals more than 500 hours.
5. You materially participated in the activity for any five of the preceding 10 tax years.
6. The activity is a personal service activity in which you materially participated in any three previous tax years.
7. Regardless of the number of hours, based on all the facts and circumstances, you participate in the activity on a regular, continuous and substantial basis.

The rules are more restrictive for limited partners, who can establish material participation only by satisfying tests 1, 5 or 6. If you have questions about meeting the material participation tests, please contact us.

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