February 22, 2012

Members of LLC's: They're Not as Limited as the IRS Would Like

By: Ezra Dyckman and Libin S. Zhang

The passive activity loss rules of the Internal Revenue Code were introduced in 1986 in order to combat tax shelters. These rules prevent an individual taxpayer from deducting his share of losses from certain "passive" activities against that individual's active income (such as wages) or portfolio income (such as interest and dividends). Generally, losses from passive activities can only be used against income from the taxpayer's other passive activities, and disallowed passive losses are carried over to the next taxable year. The passive activity loss rules apply to individuals, including those who are partners in partnerships or shareholders in S corporations, and the rules also apply to a certain extent to closely held corporations.

A passive activity is any trade or business activity in which the taxpayer does not "materially participate," as defined by Treasury Department regulations. On November 28, 2011, the Treasury Department proposed a regulation describing for the first time how members of limited liability companies (LLCs) can materially participate in the LLCs' activities and deduct their share of the LLCs' flow-through tax losses against the members' other income.

***Ezra Dyckman** is a partner in, and **Libin S. Zhang** an associate of, the law firm of Roberts & Holland LLP.*

Background

If a taxpayer owns an interest in a flow-through entity (such as a partnership, LLC, or S corporation), the taxpayer must materially participate in the entity's activities in order for the entity's income or loss to not be passive for that tax year. An individual taxpayer materially participates in an activity for a tax year by meeting any one of seven tests, such as if the individual participates in the activity for more than 500 hours during such year. For all the material participation tests, any participation by the individual's spouse is treated as participation by the individual; it is not necessary for the spouse to own an interest in the activity, or even for the individual and spouse to file a joint tax return for the year.

If the taxpayer owns a limited partner interest in a limited partnership, and is not also a general partner, the taxpayer can prove material participation in the activities of the limited partnership using only three of the seven tests. The limited partner can only materially participate by (i) participating for more than 500 hours in the activity during the year, (ii) materially participating in any five of the ten preceding years, or (iii) materially participated in the activity for any three previous tax years (whether or not consecutive) and the activity is a personal service activity.[1] As a result, a limited partner is not allowed to use the following four material participation tests, which in the case of any other person would treat the person as materially participating in the activity:

1. The individual participates for any number of hours, and his participation constitutes substantially all of the participation in such activity of all individuals for such year.
2. The individual participates in the activity for more than 100 hours during such year, and his participation is not less than the participation of any other individual for such year.
3. The individual "significantly participates" in the activity, generally by participating for between 100 and 500 hours during the year, and his aggregate participation in all significant participation activities during such year is over 500 hours.
4. The individual participates for more than 100 hours during the year, and his participation in the activity is on a regular, continuous, and substantial basis during such year based on all the facts and circumstances.

As a practical matter, limited partners are usually forced to prove 500 hours of participation in the relevant year.

New Regulation

In several cases the Internal Revenue Service unsuccessfully argued that a member of an LLC should be treated like a limited partner in a limited partnership and thus be restricted to only three of the seven tests in proving the member's material participation.[2] The courts allowed the LLC members in those cases to use all seven tests to show their material participation in the LLC's activities.

In response to the string of IRS defeats, on November 28, 2011 the Treasury issued Proposed Treasury Regulation § 1.469-5, which provided that an LLC member must be treated as a limited partner (and thus allowed only three material participation tests) if (i) the LLC is treated as a partnership for federal income tax purposes and (ii) the member does not have rights to manage the LLC at all times during the LLC's tax year under the laws of the LLC's state of organization and under the LLC's governing agreement. The preamble to the regulation provides that one type of LLC managing right is the power to bind the LLC. Thus, a managing member of an LLC would be able to prove material participation using all seven tests, while a non-managing member of an LLC would be treated like a limited partner and would generally need to demonstrate that he participated more than 500 hours in the LLC's activity during the tax year (for instance, by also working as an employee or independent contractor for the LLC).

Analysis

The new proposed regulation, which becomes effective when issued in final form, may not have a significant effect on most real estate investors. Except for hotels and certain other rental businesses,[3] all rental activities are considered *per se* passive activities and generate only passive income or loss regardless of the investor's material participation, unless the investor is a "real estate professional." A real estate professional must generally spend more than 750 hours during the year in real property trades or businesses, and those hours must constitute more than half of his time spent performing all personal services that year. Real property trades or businesses include real property construction, condominium development, property brokerage, apartment leasing, and hotel management.[4]

For taxpayers not subject to the *per se* passive rule, the proposed regulation creates a critical distinction between LLC members who can and cannot manage the LLC. Care should be taken in drafting LLC operating agreements to specify what managing rights each LLC member has. The non-managing members of the LLC would have a more difficult time proving their material participation in the LLC in order to turn their share of the LLC's losses into non-passive losses. On the other hand, some members may prefer not to manage the LLC if the LLC is generating income, such as if the member has other passive losses that can offset the LLC's passive income.

The proposed regulation concerns only the passive activity loss rules under Code section 469, and it has no impact on any other Code provision that makes a distinction between general partners and limited partners. For example, the self-employment tax of Code section 1402 is imposed on net earnings from self-employment, which does not include any "distributive share of any item of income or loss of a limited partner" that is not a guaranteed payment for services, and the self-employment tax has its own proposed regulation from 1997 defining "limited partners."

Conclusion

It is unclear what rights constitute a right to manage the LLC, other than the power to bind the LLC. Many non-managing members of an LLC have some limited ability to influence the LLC's business decisions, such as the right to appoint or remove the LLC manager or the ability to veto acquisitions and other capital events. Hopefully the government will provide additional guidance and clarify this in the finalized regulation.

Once effective, the new regulation will become yet another complicating factor for many investors in their choice-of-entity decisions. In contrast to limited partners and LLC members, S corporation shareholders can use all seven of the material participation tests, even if the shareholder has limited liability and no ability to manage the S corporation.

---

1 A personal service activity is any activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or any other trade or business in which capital is not a material income-producing factor.

2 Thompson v. United States, 87 Fed. Cl. 728 (2009); Garnett v. Commissioner, 132 T.C. 368 (2009); Newell v. Commissioner, T.C. Memo 2010-23; Gregg v. United States, 186 F.Supp.2d 1123 (D. Or. 2000).

3 The *per se* passive activity rule does not apply to a rental activity if (i) the average period of customer use for the rented property is seven days or less, (ii) the average period of customer use for the rented property is 30 days or less, and significant personal services are provided, or (iii) extraordinary personal services are provided, such as at a hospital or boarding school. Treas. Reg. § 1.469-1T(e)(3)(ii).

4 Special limitations apply to personal services performed as an employee of a real property trade or business.