



Material participation: Why it matters for LLP and LLC owners

The passive activity loss (PAL) rules may limit your ability to deduct losses from a business structured as a limited liability partnership (LLP) or limited liability company (LLC). Depending on how your ownership interest is treated under these rules, you may have more or less flexibility to claim losses in the current year. Here's a closer look.

The basics

Under the PAL rules, you generally can use passive activity losses only to offset income from other passive activities. (Keep in mind that other limitations, such as basis and at-risk rules, may apply before the PAL rules.)

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 under the PAL rules). Disallowed losses may be carried forward to future years and deducted from passive income or recovered when the passive business interest is sold.

If you're an LLP or LLC owner, you can avoid passive treatment by materially participating in the business's activities. This allows you to use LLP or LLC losses to offset nonpassive income, such as wages, interest, dividends and capital gains.

7 factors

Material participation in this context means participation on a "regular, continuous and substantial" basis. Unless you're treated as a limited partner, you're deemed to materially

participate in a business activity during the year by meeting *one* of the following seven criteria:

1. You participate in the activity more than 500 hours during the year.
2. Your participation constitutes substantially all the 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 you participate less than one or more other people yet your participation in all your 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.

Limited partners face more restrictive rules; they can establish material participation only by satisfying criterion 1, 5 or 6.

Supporting your deductions

If you’re an LLC or LLP owner, it’s important to track the time you spend on business activities. In addition, if your spouse also participates in an activity, you can combine your hours to meet the material participation standards. Contact us for additional guidance on documenting your hours, applying the material participation test and maximizing business loss deductions.