

Investor Status

Passive Activities Material Participation



Partnerships

If your business is a limited liability company (LLC) or a limited liability partnership (LLP), you know that these structures offer liability protection and flexibility as well as tax advantages.

But they once also had a significant tax disadvantage: The IRS used to treat all LLC and LLP owners as limited partners for purposes of the passive activity loss (PAL) rules, which can result in negative tax consequences.

Fortunately, these days LLC and LLP owners can be treated as general partners, which means they can meet any one of seven “material participation” tests to avoid passive treatment.

Passive Activity Loss Rules (PALS)

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

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” for federal tax purposes).

The 7 Test



Test 1 Time

You participate in the activity at least 500 hours during the year.



Test 2 Substantial

Your participation constitutes substantially all of the participation for the year by anyone, including non-owners.



Test 3 Participation

You participate more than 100 hours and as much or more than any other person.



Test 4 Significant Activity

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 of your significant participation activities for the year totals more than 500 hours.

The 7 Test



Test 5 Duration

You materially participated in the activity for any five of the preceding 10 tax years.



Test 6 Personal Service

The activity is a personal service activity in which you materially participated in any three previous tax years.



Test 7 Continuous

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.

In many cases, meeting one of the material participation tests will require diligently tracking every hour spent on your activities associated with that business.

Contact Us

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