Material Participation Standards For Small Business LLCs

By Donald Williamson

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Williamson offers several suggestions for revising the proposed passive activity loss regulations that substitute a management rights test for limited liability in determining if a limited partner (and implicitly, a limited liability company member) may use all regulatory tests to measure material participation in a partnership or LLC. Because LLCs are the predominant choice of entity for new small businesses today and because most new jobs are being created by small businesses, it is essential to our economic growth that greater certainty be provided in the standard by which limited partners and LLC members, most of whom are individuals, may deduct start-up losses. Finally, Williamson suggests that those new standards for measuring material participation for passive activity loss purposes could be extended to the more pervasive and perplexing problem of when the distributive share of an LLC member is subject to self-employment tax.

The need for providing certainty and reducing the compliance burden on all taxpayers, especially small businesses, has received increasing attention in recent years. The relative burden of complexity and compliance is greater for smaller businesses than larger businesses, simply as a function of their size. As the IRS moves toward finalizing regulations for determining how to define material participation for purposes of the passive activity loss rules, it has an opportunity to provide clarity in an area of great importance to small businesses, many of which are organized as limited liability companies. By providing greater clarity regarding which tests can be used to determine material participation for members of LLCs, the IRS can reduce complexity and increase the certainty for small businesses trying to determine which losses can be used to offset non-passive income.

On April 30 the IRS held a public hearing on the revision of regulations proposed in November 2011 to define when a limited partner or LLC member is materially participating in his partnership or LLC.[1] The revisions would redefine material participation for a limited partner or LLC member based on the individual's management authority rather than by his personal liability. This is a significant development, particularly for small and family-owned limited partnerships or LLCs in which owners may not be personally liable for the debts of their business but remain intimately involved in its operation. The proposed regulations, however, require further refinement to encourage entrepreneurs to form and operate small businesses that are the key to our economic growth.

This article first reviews the statute, current regulations, and case law interpretations that led to the proposed regulations and then offers several alternatives for amending the proposed regulations to provide sufficient incentive for entrepreneurs to invest in activities that might initially incur losses. The article then suggests several examples that could be included in the final regulations to show entrepreneurs how they should form and conduct their businesses to prevent technical foot faults that might disallow the deduction of start-up losses. Without these refinements, the regulations will continue to hamper limited partners and LLC members who materially participate in their entities from deducting losses against non-passive income, thereby decreasing the funds available for start-up businesses and discouraging start-up ventures that are the key to long-term economic growth.

A. Meaning of Material Participation

Individuals and some other taxpayers may not deduct passive losses from income that is not passive.[2] Also, beginning in 2013, net investment income on which the 3.8 percent Medicare contribution tax is paid will include gross income from passive activities.[3] For these purposes, a passive activity is any trade or business in which the taxpayer does not "materially participate," defined as the taxpayer's involvement in the activity on a "regular, continuous and substantial" basis.[4]

The regulations define an individual's regular, continuous, and substantial activity as one that meets any of these seven tests:

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[1]Prop. reg. section 1.469-5(e); REG-109369-10, *Doc 2011-24695*, *2011 TNT 228-9*. *See* Amy S. Elliott, "Witnesses Ask for Changes to Material Participation Regs," *Tax Notes*, May 7, 2012, p. 699, *Doc 2012-9196*, or *2012 TNT 84-2*.

[2]Section 469(a)(1). However, for individuals with adjusted gross income of less than $150,000 for a tax year, up to $25,000 of otherwise passive losses from rental real estate activities may offset non-passive income. *See* section 469(i).

[3]*See* section 1511(a)(1)(A), (c)(1)(A)(i), and (c)(2)(A).

[4]Section 469(c)(1) and (h)(1).

1. Participation in the activity is for more than 500 hours during the tax year.[5]

2. Participation in the activity for the tax year constitutes substantially all of the participation in the activity by all individuals, including those who do not own interests in the activity.[6]

3. Participation in the activity is for more than 100 hours during the tax year and the individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual, including individuals who are not owners of interests in the activity.[7]

4. There is significant participation in the activity (generally 100 hours) for the tax year, and the individual's aggregate participation in all significant participation activities during the tax year exceeds 500 hours.[8]

5. There is material participation in the activity for any five tax years (whether or not consecutive) during the 10 tax years immediately preceding the tax year under consideration.[9]

6. There is material participation in a personal service activity in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor for any three tax years (whether or not consecutive) preceding the tax year under consideration.[10]

7. Based on all the facts and circumstances, participation in the activity is otherwise regular, continuous, and substantial during the tax year.[11] However, under this alternative, management service is taken into account only if no other individual received compensation for management services nor devoted more hours of service in connection with management of the activity.[12]

Also, except as provided in regulations, the statute deems that no limited partner (and implicitly no LLC member) can materially participate in activities of his partnership or LLC.[13] Despite this prohibition, the current regulations treat a limited partner, and implicitly LLC members, as materially participating in an entity if the partner meets the participation standards in numbers 1, 5, or 6 above.[14] For this purpose, a partner or LLC member is a limited partner if:

- his interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether under applicable state law the individual is personally liable for the obligations of the entity; or
- the individual's liability for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount.[15]

This definition does not apply to a limited partner who is also a general partner of the partnership at all times during the tax year. Consequently, an individual who holds both a limited and general partnership interest could use all seven alternatives in measuring material participation regarding both interests.[16]

Given that many, if not most, closely owned businesses, including family-owned businesses, are operated today as LLCs, the current regulations place LLC members at a distinct disadvantage relative to general partners. When these definitions of material participation and limited partnership interests were promulgated in 1988, there were few, if any, LLCs in existence. After the first formal ruling by the IRS that an LLC organized under Wyoming law was a partnership for federal tax purposes,[17] all states have enacted LLC statutes. Following the check-the-box regulations promulgated in 1997, any domestic LLC is considered a partnership for tax purposes unless an affirmative election is made to be treated as a corporation.[18]

B. Material Participation and LLC Member

Because LLCs generally possess both the passthrough tax quality of partnerships and the limited liability available to shareholders of corporations, they have become the entity of choice for most small, start-up businesses in America. But until the proposed regulations were promulgated last November, there was no regulatory guidance addressing whether an LLC member is treated as a limited or general partner under the passive activity loss rules. Court cases filled the gap.

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[5]Reg. section 1.469-5T(a)(1).
[6]Reg. section 1.469-5T(a)(2).
[7]Reg. section 1.469-5T(a)(3).
[8]Reg. section 1.469-5T(a)(4) and (c).
[9]Reg. section 1.469-5T(a)(5).
[10]Reg. section 1.469-5T(a)(6).
[11]Reg. section 1.469-5T(a)(7).
[12]Reg. section 1.469-5T(b)(2).
[13]Section 469(h)(2).
[14]Reg. section 1.469-5T(e)(2).
[15]Reg. section 1.469-5T(e)(3).
[16]Reg. section 1.469-5T(e)(3)(ii).
[17]Rev. Rul. 88-76, 1988-2 C.B. 360.
[18]*See generally* reg. section 301.7701-3.

In 2000 *Gregg v. United States*[19] was the first case to consider whether only three of the seven tests for measuring material participation under the passive activity loss regulations are available to LLC members. Although Gregg had limited liability for the debts of his LLC, the court found the regulations' definition of a limited partnership interest did not apply to LLC members. The court concluded that absent a regulation asserting that an LLC member should be treated as a limited partner, LLC members were entitled to use any of the seven tests for measuring their material participation.

Surprisingly, the issue did not arise again until 2009, in *Garnett v. Commissioner*,[20] in which the IRS once more argued that the petitioner's interests in several LLCs were limited partnership interests because of the taxpayer's limited liability for the LLCs' debts. Unlike the district court in *Gregg*, the Tax Court focused on the regulations' general partner exception to the definition of limited partner, finding that under Iowa law, limited partners could lose their limited liability if they participated in management. Because the state LLC statute permitted LLC members to participate in management, the court held they should be considered general partners for tax purposes, entitling them to use all seven tests for measuring their participation in the LLC.

Shortly thereafter, the Court of Federal Claims in *Thompson v. United States*[21] took yet another approach in finding that an LLC member was not a limited partner for purposes of measuring his material participation in the entity. Although the individual member owned 99 percent and managed a Texas LLC, the court found the LLC itself was not a partnership, so the regulations applicable to limited partners limiting their alternatives for measuring material participation were inapplicable to LLC members. Further, the court noted that the legislative history to the passive activity loss rules stated that the limitation on material participation for limited partners was created because they were not permitted to participate in management. Therefore, because LLC members can and frequently do participate in management, the court found the regulations inapplicable.

Following these decisions, the Tax Court in *Newell v. Commissioner*[22] and *Hegarty v. Commissioner*[23] held that the managing member of an LLC could use all seven tests to determine material participation and was not limited to the three tests available to limited partners.

C. Proposed Regulations

In the face of these defeats in the Tax Court, District Court of Oregon, and Court of Federal Claims, the IRS issued proposed regulations on November 28, 2011, modifying the definition of a limited partnership interest for purposes of determining material participation under the passive activity loss rules.[24] The proposed regulations reject the approach of the *Thompson* court finding an LLC not to be a partnership for tax purposes and instead provide that an interest in an LLC is the equivalent of a partnership interest based on the general rule of the CTB regulations that any unincorporated business entity is a partnership unless an affirmative election is made to be a corporation.[25] Therefore, if an LLC does not elect to be a corporation for tax purposes, it will be treated as a partnership for purposes of the passive loss rules.

The proposed regulations then define a limited partnership interest to be one that does not permit "rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement."[26] Thus, the proposed regulations substitute a management rights standard for limited liability as the criterion for determining whether a limited partner or LLC member has just three or all seven tests available to determine if the partner's or member's participation is material. This approach generally conforms to the standards adopted by the courts in carrying out the purpose of restricting limited partners from being considered as materially participating in partnership activities because they lack management rights.

As the courts noted, the congressional purpose for limiting the finding of material participation for limited partners (and by analogy LLC members) was based on their inability under most state laws to actively manage the business. With the advent of LLCs, which permit members both limited liability and active day-to-day management authority, the proposed regulations' substitution of management rights for limited liability reflects the purpose of the

[19]186 F. Supp.2d 1123 (D. Or. 2000), *Doc 2001-632*, *2001 TNT 3-11*.

[20]132 T.C. 368 (2009), *Doc 2009-14978*, *2009 TNT 124-43*.

[21]87 Fed. Cl. 728 (2009), *Doc 2009-16426*, *2009 TNT 138-4*, *acq. in result only*, AOD 2010-02, 2010-14 IRB 515, *Doc 2010-5068*, *2010 TNT 46-15*.

[22]T.C. Memo. 2010-23, *Doc 2010-3290*, *2010 TNT 31-9*.

[23]T.C. Summ. Op. 2009-153, *Doc 2009-22094*, *2009 TNT 192-11*.

[24]Prop. reg. section 1.469-5(e).

[25]Prop. reg. section 1.469-5(e)(3)(i)(A), citing reg. section 301.7701-3.

[26]Prop. reg. section 1.469-5(e)(3)(1)(B).

statute and that of the current regulations of limiting the alternatives available for measuring material participation of partners who do not have management rights.

D. Right to Manage Test

Because the proposed regulations look to the ability of an LLC member to manage the affairs of the LLC rather than to whether the member has limited liability for the debts of the entity, individuals who actively operate LLCs will now be able to offset their start-up losses against non-passive income. Replacing the personal liability test with a management test is important for the small business community where individuals often come together to conduct business under an arrangement in which some owners are charged to manage the activity and others only contribute capital. This combination of talented people joining with investors to form LLCs is the classic arrangement for start-up businesses. Consequently, the regulations must take great care defining when an LLC member has rights to manage the entity at all times during the entity's tax year under the law of the jurisdiction in which the entity is organized and under the governing agreement.[27]

In particular, there are two key areas for which further detail and clarity are important.

1. Governing agreement and facts and circumstances. First, the proposed regulations should make clear that the governing agreement controls what management powers the partners or members have, looking to state law only where the agreement is otherwise silent or in violation of state law. Further, the regulations should provide that the governing agreement include not only the entity's organizing document, if any, but also other documents setting out the owners' powers and responsibilities. Frequently, small businesses will not have formal written agreements describing the rights and relationships of the parties, but there may be letters of understanding or other memoranda setting out the parties' intent about who has management authority and the extent of that authority. Since small businesses will often not have formal documents describing the relationship of the parties, the regulations should acknowledge that all facts and circumstances be taken into account in finding what management rights each owner possesses.

While this approach may result in a case-by-case analysis, a factual inquiry is necessary because of the variety of arrangements that exist in small businesses today, and often the owner's intent can only be ascertained by examining the particular circumstances of each arrangement. Nevertheless, to provide the clarity small businesses need, the regulations should include examples similar to the following to illustrate the facts and circumstances standard for ascertaining an LLC member's management rights in some fairly common situations:

> **Example 1:** A state's LLC statute provides that all members or partners have management rights unless the entity's organization documents provide otherwise. The LLC's operating agreement states that only member X is charged with managing the affairs of the LLC. Therefore, X has rights to manage and other members do not.
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> **Example 2:** When a state's LLC statute provides that differences among members regarding the conduct of the LLC's business be resolved by majority vote of the members, all LLC members possess rights to manage.
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> **Example 3:** An LLC's operating agreement expressly provides that management decisions are vested in one member and that this managing member may be removed at any time by a majority vote of the members. Only the managing member possesses rights to manage.
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> **Example 4:** An LLC's operating agreement prescribes that one LLC member has exclusive authority to make decisions or take actions regarding a specific list of matters. The operating agreement also has a prescribed list of decisions and actions that require the consent of all members. The managing member with specific powers may be removed at any time by majority vote of all members. All members of the LLC possess rights to manage.

Examples such as the above would bring greater clarity to the meaning of the phrase ''rights to manage'' in some frequently occurring situations and would assist business owners in structuring start-up ventures.

2. Definition of management rights. The second critical area where further detail and clarity would be helpful is in the definition of management rights. The proposed regulations hinge the right to use all seven tests for measuring material participation on the individual owner's ''rights to manage'' the LLC at all times during the tax year. However, surprisingly, the regulations provide no definition of the term beyond a reference in the regulation's preamble that such rights include a power to bind the

[27] *Id.*

entity.[28] If this omission were based on a presumption that state law would define management rights, the regulations should state that taxpayers should look to local law or the Revised Uniform Limited Partnership Act for what constitutes the right to manage the LLC.

In any event, a clear definition of what constitutes rights to manage is critical to the proper functioning of the regulations because small businesses, especially start-up ventures, usually cannot afford to consult with counsel or other technical experts to interpret provisions of state statutes. At a minimum, the regulations should state that an individual possesses the rights to manage the LLC if he can legally bind the entity to contracts under the law of the state under which the entity is organized or under the entity's operating agreement. Also, to facilitate understanding of what constitutes management rights for this purpose, examples similar to the following could be provided to illustrate the meaning of the phrase:

> **Example 5:** The operating agreement of an LLC appoints Mr. X its chief operating officer with power to contractually bind the LLC. Mr. X is eligible to use all seven tests to determine material participation.
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> **Example 6:** Mr. Y, a member of the XYZ LLC, has no rights to participate in the management of XYZ. Rather XYZ's operating agreement directs that Z, itself an LLC, may enter into binding contracts. If Z is wholly owned by Mr. Y, then Mr. Y is eligible to use all seven tests for purposes of determining material participation.
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> **Example 7:** Mr. A is a member of ABC LLC, which in turn is a general partner in a partnership in which Mr. A is also a general partner. While Mr. A has management rights in the partnership by virtue of being a general partner, he has no management rights in ABC. Mr. A cannot use all seven tests to determine material participation in ABC.
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> **Example 8:** Mr. B owns a 1 percent interest as managing member of an LLC and a 20 percent interest in the same LLC as a non-managing member. Because of the general partner exception, B's management rights enable him to use all seven tests in measuring his material participation regarding both LLC interests.

Defining a threshold standard for the meaning of rights to manage and then supplementing that standard with examples such as those above will afford small business owners the needed clarity to understand the tax consequences of their business decisions. Regardless of the leniency or narrowness of a rule, the small business community first and foremost must be able to easily understand a rule if they are to ultimately comply with it. The definitions and examples set out here will enable small business persons to do just that when it comes to determining material participation in an LLC for purposes of the passive activity loss rules.

E. Self-Employment Tax Issues

Finally, and perhaps of greater importance to the small business community, the proposed regulatory definition of limited partner under the passive activity loss rules offers an opportunity to resolve a long-standing issue regarding the definition of limited partner for purposes of the applicability of the self-employment tax on distributive shares attributable to LLC members. Generally, except for guaranteed payments for services, a limited partner is not subject to self-employment tax.[29] However, like the application of the passive activity loss rules to LLC members, the definition of a limited partner for self-employment tax purposes has remained unresolved for decades, and in fact is of greater significance to small business persons whose self-employment tax can often exceed their income tax.

In January 1997 the IRS issued proposed regulations clarifying the limited partner exception to self-employment tax generally establishing a 500-hour service test similar to the material participation standard for the passive loss proposed regulations.[30] However, Congress promptly imposed a one-year moratorium stopping the IRS from adopting regulations dealing with the employment tax treatment of limited partners.[31] While the moratorium expired on July 1, 1998, the proposed regulations have never been finalized and the scope of the limited partner exemption from the self-employment tax and its application to members of LLCs remains unknown, creating uncertainty among small business owners and in some cases leading to abuse.[32]

Unfortunately, the preamble to the proposed passive activity loss material participation regulations states that no inference is intended for any

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[28]*See* REG-109369-10.

[29]Section 1402(a)(13).

[30]Prop. reg. section 1.1402(a)-2(h).

[31]Section 935 (moratorium on some regulations) of the Taxpayer Relief Act of 1997, P.L. 105-34.

[32]*See, e.g., Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011), *Doc 2011-2868*, *2011 TNT 28-11*, in which service partners of a limited liability partnership claimed exemption from self-employment tax.

other provisions of the IRC, including the self-employment tax.[33] Given that the self-employment tax is intended to apply to an individual's earnings from personal effort, the proposed passive activity loss rules that employ a rights to manage standard seems appropriate for also determining if a partner or LLC member should be subject to self-employment tax. Thus, a limited partner for self-employment tax purposes could be defined as a partner who does not materially participate in the entity's activities under the rights to manage standard. Having the same test for measuring material participation for both passive activity loss and self-employment tax purposes affords the consistency, simplicity, and clarity needed by small business persons.

F. Conclusion

Because the proposed regulations defining limited partner for passive activity loss purposes are not final, small businesses are left with the existing temporary regulations in determining if members are material participants in their LLCs. But because the proposed regulations generally conform to the existing case law substituting a management test for a limited liability test for LLC members, taxpayers should have substantial authority in following the approach set forth in the proposed regulations. However, given that the IRS has stated that the proposed regulations may not be relied on for any purpose other than the passive activity loss rules, they cannot be used to characterize amounts for self-employment tax.

The proposed passive activity loss regulations are a good first step in providing guidance for closely held LLCs, including family-owned businesses, to operate in a manner that will encourage the growth of small businesses. Also, if revisions and examples similar to those suggested above are incorporated into the final regulations, the IRS will have taken a significant step in providing clarity and certainty in this previously murky and controversial area of the tax law. Hopefully, this same approach can be used to resolve the issue of who is a limited partner for self-employment tax purposes as well.

[33] REG-109369-10.