

Three new cases from the US Tax Court make it much easier for LLC owners to deduct losses from their business on which they have spent only a few hours a week.

BACKGROUND

The IRS until very recently, used to treat tax losses generated in an LLC where the owners had spent a few hours a week as passive activity losses. Passive activity losses are undesirable because they could be deducted only against other passive activity losses. Since most business owners do not have passive losses from various sources, passive activity losses had to be carried into future years, if and when such losses could be deducted.

In fact, the IRS treated LLC owners as limited partners for purposes of passive activity loss rules. This meant an LLC owner to overcome the passive activity losses had to pass *one* of the following tests.

- **More Than 500-Hour Test:** This required an LLC owner to participate in the loss-generating business more than 500 hours a year.
- **Prior-Year Material Participation Test:** To pass it, LLC owner must have materially participated in the business any five of the last 10 years.
- **Personal-Service Activity Test:** To pass, the LLC business must have been a personal service activity in which the owner materially participated for the last three years.

GOOD NEWS

However, very recently the US Tax Court decided LLC owners should be subject to less stringent tests reserved for material participation. This means an LLC owner could deduct losses generated in business if one of the following tests is overcome:

- **Substantially-All Test:** You pass this test, if you do all the work yourself in a given year, even if it does not take much time. Or,
- **More-Than-100-Hours Test:** You pass this test as an LLC owner, if you spend more than 100 hours a year, *AND* no other individual participates more than you. This means not a lot a time required to spend on the business.

CAVEAT

This passive-activity loss rule *DOES NOT* apply to you, if your loss-generating LLC is a rental operation. Rental activity losses from LLC or otherwise are passive activity losses.

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