

PCS Tax Insight

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New material participation proposed regulations provide taxpayer-favorable guidance

The new material participation proposed regulations (REG-109369-10) provides taxpayer-favorable guidance concerning the definition of an "interest in a limited partnership as a limited partner" for purposes of the passive activity loss rules under section 469. The proposed regulations would potentially make it easier for limited partners and LLC members to qualify for the material participation test and thus exempt from the passive activity loss rules.

On November 25, 2011, the Treasury Department released proposed regulations (REG-109369-10) concerning the definition of an "interest in a limited partnership as a limited partner." The proposed regulations provide guidance that helps determine whether a taxpayer materially participates in an activity for purposes of the passive activity loss rules under section 469. The proposed regulations will potentially make it easier for limited partners and LLC members to qualify for the material participation test described below and thus exempt from the passive activity loss rules.

Background

Section 469 limits the ability of certain taxpayers to deduct losses from passive activities. The purpose of section 469 is to prevent the use of losses from passive activities against a taxpayer's

non-passive income. The passive loss rules allow the use of passive losses only against passive income; excess losses can be carried over to another tax year. Suspended passive losses may be deducted in full in the year of disposition of the passive activities.

A passive activity is defined as a trade or business in which the taxpayer does not materially participate. Material participation is defined by statute as "regular, continuous, and substantial" involvement in the business operations. The temporary regulations under section 469 provide seven exclusive bright-line tests for determining material participation in an activity. Reg. sec. 1.469-5T(a)

Under the current rules prescribed in those temporary regulations, an individual taxpayer is treated as materially participating in an activity



for the tax year if : (1) the individual participates in the activity for more than 500 hours during the year, (2) the individual's participation constitutes substantially all of the participation in the activity, (3) the individual participates for more than 100 hours and no other individual participates more than such individual, (4) the activity is a significant participation activity and the individual's participation in all significant participation activities exceeds 500 hours, (5) the individual materially participated for any five of the last 10 tax years, (6) the activity is a personal service activity and the individual materially participated for any three prior years, or (7) based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis.

Losses from limited partners holding limited partnership interests are per se passive, except to the extent provided in regulations. The above temporary regulations constrained limited partners to the use of only three of the seven tests to prove material participation—tests (1), (5), and (6) above—so it is significantly more difficult for limited partners to avoid the passive loss limitations. Under the temporary regulations, a limited partnership interest is defined as either one that is designated as such in the partnership agreement, or the liability of the holder of the interest is limited to a determinable, fixed amount.

Since 2000, the courts have consistently concluded on a number of occasions that a limited liability company (LLC) interest or a limited liability partnership (LLP) interest is not a limited partnership interest for purposes of applying the section 469 material participation tests. The IRS contended in all of these cases that if a

LLC or a LLP is treated as a partnership for federal tax purposes and the liability of its members or partners for obligations of the partnership is limited to a fixed amount, then the LLC or LLP interest should be treated as a limited partnership interest, restricting the taxpayer to the use of only three of the seven tests to prove material participation. In all of the cases, however, the courts disagreed with the IRS's position and permitted the LLC or LLP member to use all seven tests for determining material participation in an activity.

Summary of proposed regulations

Prop. Reg. sec. 1.469-5 may be summarized as follows:

1. The proposed regulations would revise the definition of a limited partner interest in a limited partnership. Under the proposed regulations, an interest would be treated as a limited partner interest in a limited partnership if:
 - (a) The entity is classified as a partnership for federal income tax purposes, and
 - (b) The holder of the interest does not have rights to manage the entity at all times during the entity's tax year under the law of the jurisdiction in which the entity was organized under the governing agreement. Rights to manage include the power to bind the entity.
2. The proposed regulations also would provide two exceptions:
 - (a) First, if the individual satisfies the requirements for material participation in an activity during the year under Reg. sec.

1.469-5T(a)(1) relating to participation for 500 hours or more, (a)(5) relating to participation for five of the preceding 10 years, or (a)(6) relating to participation in a personal service activity for three years, then the individual's share of income, gain, loss, deduction, or credit from the interest would not be treated as passive.

- (b) Second, if the partner holds both a limited and non-limited partnership interest (such as a general partnership interest), the partner would not be treated as a limited partner.
- 3. The proposed regulations would eliminate the current section 469 regulations' reliance on limited liability for purposes of defining a limited partner.
- 4. The proposed regulations would adopt an approach that relies on the partner's participation in the management of the entity.
- 5. The proposed regulations would apply only for purposes of section 469; they would not apply for other provisions of the Code (including, for example, the Self-Employment Contribution Act (SECA) tax).
- 6. The regulations would be effective for partnership tax years beginning on or after the date of publication of final regulations.

Consequences of proposed regulations

Section 469(h)(2) provides a presumption that losses from interests in limited partnerships are passive. The regulations under section 469(h)(2) were drafted at a time when

limited partners could lose their limited liability protection if they participated in the management of the partnership. However, today limited partners and LLC members may participate in the management and control of the partnership without losing their limited liability. The proposed regulations acknowledge this change and would eliminate the current regulations' reliance on limited liability for purposes of determining whether an interest is a limited partner interest under section 469(h)(2). They instead would adopt an approach that relies on the individual partner's right to participate in the management of the entity.

Limited partners and LLC members generally do not have a limit on their ability to participate in the management of the entity; as a result, these partners or members would not be treated as limited partners under the proposed regulations and would be permitted to use all seven tests to avoid the passive loss limitations under section 469. Thus, under the regulations, if finalized, it would be easier for limited partners and LLC members to demonstrate material participation because the partners or members no longer would be limited to only three of the seven material participation tests.

How PwC can help

Under the recently enacted Patient Protection and Affordable Care Act, a new 3.8-percent tax on net investment income will be imposed for tax years beginning in 2013. Net investment income is defined broadly to include any income from limited partnerships and/or from other pass-through entities in which a taxpayer does not materially participate. As a result, taxpayers now have an added incentive to materially participate in activities in

order to reduce the risk of being subject to this additional tax. Note that an additional 0.9-percent medical hospital insurance tax, which also was enacted as part of the Patient and Affordable Care Act, is unaffected by the new proposed regulations.

The proposed regulations of section 469 would prospectively increase certainty around material participation. PwC may assist pass-through entities in achieving a higher level of certainty of material participation through a "material participation analysis," which

may involve, among other items, conducting a study of a partner's activities, developing and maintaining corroborating documentation, and providing advice regarding the appropriate activity groupings for material participation. As a result, partners of pass-through entities may gain increased certainty concerning material participation, thereby potentially opening the door for significant tax savings while not being limited by the passive activity loss rules.

For more information, please do not hesitate to contact:

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