

Milbank Tax Attorney Suggests Updating Regulations on Material Participation by LLC Members



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Michael J. Grace, an attorney in Milbank's Washington, DC office, has published a BNA Insights Report, "Courts Confused About Passive Activity Material Participation Standards for Limited Liability Companies, but Regulations Could Use Updating." Michael's article appeared June 29, 2010 in the Daily Tax Report, published by BNA, Inc. At the IRS National Office (Washington, DC), Michael served as Principal Author of pertinent tax regulations issued in 1988.

The article addresses a particular application of Section 469 of the Internal Revenue Code, which limits taxpayers' ability to use passive activity losses and credits. A "passive activity" generally includes any activity in which a taxpayer does not "materially participate." By statute, a taxpayer materially participates in an activity by participating in it regularly, continuously, and substantially; see Internal Revenue Code Section 469 (h)(1). Under tax regulations, an individual generally may satisfy this standard by meeting any of seven alternative tests. However, under the regulations as currently written, a member of a limited liability company ("LLC") may use only three of the seven tests.

In recent years, courts in five reported cases have questioned this result for LLCs. Disagreeing with the regulations, the courts have concluded that a member of a LLC may materially participate in an activity by satisfying any of the seven generally applicable tests. Basically, the courts have made it easier than the regulations for a LLC member to satisfy the material participation standard, enabling the member to utilize on the member's income tax returns losses and credits from a LLC.

Michael's article reviews the pertinent statutes and legislative history, explains why the regulations were written as they now provide, proposes that the regulations be amended so that they no longer limit a LLC member to three of the seven generally applicable tests, and suggests amending language. You may view Michael's article by clicking [here](#). Readers wishing to discuss these issues with Michael may contact him at (202) 835-7532 or mgrace@milbank.com.

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