

To deduct business losses, you may have to prove “material participation”

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You can only deduct losses from an S corporation, partnership or LLC if you “materially participate” in the business. If you don’t, your losses are generally “passive” and can only be used to offset income from other passive activities. Any excess passive loss is suspended and must be carried forward to future years.

Material participation is determined based on the time you spend in a business activity. For most business owners, the issue rarely arises — you probably spend more than 40 hours per week working on your enterprise. However, there are situations when the IRS questions participation.

Several tests

To materially participate, you must spend time on an activity on a regular, continuous and substantial basis.

The regulations provide that the taxpayer materially participates if and only if he meets one of seven tests.

For example, a taxpayer must:

1. Work 500 hours or more during the year in the activity;
2. Participate in the activity for more than 100 hours during the year, with no one else working more than the taxpayer; or
3. Materially participate in the activity for any five taxable years during the 10 tax years immediately preceding the taxable year. This can apply to a business owner in the early years of retirement.

There are other situations in which you can qualify for material participation. For example, you can qualify if the business is a personal service activity (such as medicine or law). There are also situations, such as rental businesses, where it is more difficult to claim material participation. In those trades or businesses, you must work more hours and meet additional tests.

Proving your involvement

In some cases, a taxpayer does materially participate, but can’t prove it to the IRS. That’s where good recordkeeping comes in. A good, contemporaneous diary or log can forestall an IRS challenge. Log visits to customers or vendors and trips to sites and banks, as well as time spent doing Internet research. Indicate the time spent. If you’re audited, it will generally occur a few years from now. Without good records, you’ll have trouble remembering everything you did.

Passive activity losses are a complicated area of the tax code. Please consult with your tax adviser for more information on your situation.

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The Law Office of Eugene Gorin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorin@gorinlaw.com
www.gorinlaw.com