Clear 3 hurdles to deduct losses passed through your LLC

If your company creates a side business, you'll definitely want to consider structuring it as a limited liability company (LLC) owned by you. You'd enjoy multiple tax benefits, such as:

• You can deduct your share of losses on your personal tax return. If you hold a 25 percent interest in an LLC, for example, and the LLC incurs a $400,000 loss, you can qualify for a $100,000 deduction.

• You won't pay corporate income tax when the business turns a profit. An LLC, like an S corp or a partnership, isn't subject to the corporate income tax.

• Your personal assets will enjoy the same liability protection as they would if you incorporate your company.

• You don't need to meet all the criteria required of S corps. For example, you can select a foreign co-owner.

Shelter your SE taxes

Finally, an LLC can provide shelter from self-employment taxes. For example, say your self-employment income is subject to self-employment (SE) tax. You run up a $100,000 loss from a new LLC. In some situations, LLC losses reduce SE tax as well as income tax.

To receive this double tax break, you must be treated as a general partner. That is, you need written authority to contract on the LLC's behalf.

But if your new LLC starts showing a profit after a few years, your share of the profits are subject to SE tax. At that point, you can elect S corporation status for this business, assuming it meets the requirements. Once your business becomes an S corporation, only your compensation—not corporate profits—is subject to SE tax.

The 3 hurdles

Key point: You must clear three main hurdles, though, if you want to deduct a loss that's passed through from an LLC.

1. Have an adequate basis. For example, a $100,000 loss is deductible if you have, say, $150,000 in basis. But if your basis is $20,000, only $20,000 is deductible.

To get basis in your LLC, you can make cash and property contributions. Your share of the LLC's debt is also included in your basis.

Suppose you are the sole owner of an LLC that borrows $250,000 from a lender. This loan increases your basis by $250,000.

2. Prove your amount at-risk. To take a loss deduction, you must also meet the so-called "at-risk" rules.

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Those rules are satisfied with a personal guarantee of some or all the LLCs debt.

Other methods can increase the at-risk amount. You can formally agree to make future cash contributions to the LLC or you can use unrelated property to secure the LLC's debt.

3. Choose active loss or passive loss. Finally, you need an "active" rather than a "passive" LLC loss to deduct it against your ordinary income. If you participate in the LLC's business at least 500 hours a year, your LLC loss is active.

But you may actually prefer a passive loss, instead, if you want to offset passive income, such as income from a rental property.

By adjusting your work schedule, you can wind up with a passive or an active loss, whichever provides the most tax shelter.

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