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RaPower3, LLC
Neldon Johnson
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Sent via email to neldon@iaus.com, original will follow

Re.: *Response to tax questions posed.*

Dear Mr. Johnson,

Last week you had several questions regarding tax liability for members of RaPower3's multi level marketing organization ("Member") and you wanted information on how to get a private letter ruling from the IRS on the same. This letter is to provide facts on each issue as stated below. This information is relevant only to individuals acting as sole proprietors in the multi level organization of RaPower3. Different rules apply to corporations and other entities.

I. Will the Taxpayer's participation be deemed "Material Participation" as defined in the Internal Revenue Code?

Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of his or her participation. This gave rise to significant numbers of tax shelters that allowed taxpayers to deduct non-economic losses against wages and investment income. The Tax Reform Act of 1986 added IRC § 469, which limits the taxpayer's ability to deduct losses from businesses in which he or she does not materially participate and from rental activities.

If an activity or the participation in the activity is determined to be passive, this does not mean that the taxpayer may not deduct the expense. The expenses are deemed

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Denise M. Thomas, CRR/RPR

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to be passive losses and are still deductible if the taxpayer has passive income from other sources. Passive income is determined by the same passive/active rules that apply to losses.

A. EQUIPMENT LEASING AS A PASSIVE ACTIVITY

In general, losses generated from equipment leasing are considered to be passive. *I.R.C. § 469(c)(2) & (4)*. The material participation standard, as defined later, will normally not apply to long-term equipment rentals, thus equipment leasing losses would be passive regardless of the level of participation.

There are, however, six exceptions to this general rule. *Treas. Reg. § 1.469-1T(e)*. Activities meeting one of the six exceptions are treated as businesses. A taxpayer must then materially participate in order to treat the gain/loss as non-passive. Equipment rental is not a rental activity and thus passive activity in the following situations:

a. **The average period of customer use for such property is seven days or less.** An example of this would be when Home Depot rents out tools and the average customer is only going to use the equipment for a few days and then return it.
b. **The average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers.** This would be similar to a construction company that bills out the cost of backhoe hours as well as the driver operating the machine. The backhoe will probably be on the jobsite for longer than 7 days, but the overall purpose of the transaction is to have the operator using the backhoe to further the construction project.
c. **Extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use).** The use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.
d. **The rental of such property is treated as incidental to nonrental activity of the taxpayer.** Treasury Regulation 1.469-1T(e)(3)(v) further explains that rental property would be incidental to a nonrental activity of the taxpayer in the following situations:

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a. **Property held for investment. The rental of property during a taxable year shall be treated as incidental to an activity of holding such property for investment if and only if –**
   i. **The principal purpose for holding the property during such taxable year is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and**
   ii. **The gross rental income from the property for such taxable year is less than two percent of the lesser of –**
      1. **The unadjusted basis of such property; and**
      2. **The fair market value of such property.**

b. **Property used in a trade or business. The rental property during a taxable year shall be treated as incidental to a trade or business activity if and only if –**
   i. **The taxpayer owns an interest in such trade or business activity during the taxable year;**
   ii. **The property was predominantly used in such trade or business activity during the taxable year; and**
   iii. **The gross rental income from such property for the taxable year is less than two percent of the lesser of –**
      1. **The unadjusted basis of such property; and**
      2. **The fair market value of such property.**

e. **The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers.** This is again similar to Home Depot renting out its tools to walk-in customers.

f. **The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity.** In this exception, the equipment is essentially being leased back to the taxpayer in a different venture.

In order for the lease of equipment from the taxpayer to IAS for marketing purposes to be considered active loss or income, the transaction would have to fit into one of the exceptions listed above. The best argument the taxpayer could make is to state the rental is incidental to a nonrental activity of the taxpayer. The nonrental activity would be holding the property for investment as described above. For this exception to apply, the taxpayer must show that the principal purpose for having the equipment is to realize gain from the appreciation of the equipment and then the gross rental income cannot be more than two percent of either the fair market value of the

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equipment or the unadjusted basis of the equipment (what you paid for it) whichever amount is lesser. If the taxpayer paid $1,000 for the equipment, the most he could collect in rent for that year is $19.99 to still qualify under this exception.

If the taxpayer does determine that he qualifies for an exception from the rule that all equipment rental income and losses are passive, he must still pass the material participation requirement for a sole proprietorship.

B. MATERIAL PARTICIPATION FOR A SOLE PROPRIETORSHIP

Income and losses from a sole proprietorship will be considered passive activity unless the taxpayer materially participates in the business. If losses are determined to be passive, they are generally not deductible in the absence of passive income from another source.

A taxpayer materially participates in an activity if he or she works on a regular, continuous and substantial basis in operations. *I.R.C. § 469(h)(1)*. There are seven tests for material participation and the taxpayer only has to meet any one of the requirements under Treasury Regulation 1.469-5T. The tests are as follows:

a. The taxpayer works 500 hours or more during the year in the activity.
b. The taxpayer does substantially all the work in the activity.
c. The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer.
d. The activity is a significant participation activity (SPA), and the sum of SPAs in which the taxpayer works 100 to 500 hours exceeds 500 hours for the year.
e. The taxpayer materially participated in the activity in any 5 of the prior 10 years.
f. The activity is a personal service activity and the taxpayer materially participated in that activity in any 3 prior years.
g. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year. However, this test only applies if the taxpayer works at least 100 hours in the activity, no one else works more hours than the taxpayer in the activity, and no one else receives compensation for managing the activity.

Stated simply, if the taxpayer does most of the work, income or loss will be non-passive. There is no specific number of hours associated with this test. In addition, the term "substantially" is not defined in the regulations. However, the involvement in the activity of an employee or non-owner could cause the taxpayer to fail this test.

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If there are others involved in the activity or business, the taxpayer must be able to prove his participation. This can be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. *Treas. Reg. § 1.469-5T(f)(4).* In the case of any person who is married for the taxable year, any participation by such person's spouse during the taxable year will be treated as participation by such person in the activity during the taxable year. *Treas. Reg. § 1.469-5T(f)(3).* Participation of children or employees is not counted towards the number of hours the taxpayer works during the year. If the taxpayer works more than 100 hours but less than 500 hours and there are other employees working in the same activity, the taxpayer must be able to prove that he is working more than anyone else.

Generally any work you do in connection with an activity in which you own an interest will be considered participation. In a multi-level marketing structure, participation would also include any activity to increase the productivity of other individuals engaged in such sales, such as recruiting, training, motivating and counseling such individuals. While the taxpayer may spend time working on various aspects of the activity, certain hours do not count in the tests for material participation:

- Investor-type activities do not count unless the taxpayer is directly involved in day-to-day management or operations. Treasury Regulation § 1.469-5T(f)(2)(ii)(B) provides that the following activities do not count unless the taxpayer is directly involved on a day-to-day basis in management or operations:
  - Studying or reviewing financial statements or reports.
  - Preparing or compiling summaries of analyses for the individual's own use.
  - Monitoring finances or operations in a non-managerial capacity.
  - (This list is not all inclusive. Other activities could include organizing records, preparing taxes, and paying bills.)
- Work not ordinarily done by an owner is not counted if it is claimed in an effort to avoid the passive loss limitations. This would be work performed by an owner that would normally be assigned to an employee. Generally the taxpayer has no reason to include these services in the hourly computations other than in an attempt to avoid disallowance of losses.

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- Travel time generally should not be considered in computing the hourly tests for material participation, particularly if other factors indicate the taxpayer is not participating in the activity on a regular, continuous and substantial basis. Legislative history provides that "services must be integral to operations". It is somewhat difficult to construe that travel constitutes "services" or "participation" as contemplated by Congress or the Regulations. More importantly, travel is not integral to operations in most cases.

Participation and contributions to the business are based on the facts of the individual taxpayer. There is no clear cut answer as to exactly what activities a trier of fact would find as participation or not. However, broad indicators that the IRS will look at to determine if the taxpayer does not materially participate include:

- The taxpayer was not compensated for services. Most individuals do not work significant hours without expecting wages or commissions.
- The taxpayer's residence is hundreds of miles from the activity.
- The taxpayer has a W-2 job requiring 40+ hours a week for which he or she receives significant compensation.
- The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.
- There is a paid on-site management/foreman/supervisor and/or employees who provide day-to-day oversight and care of the operations.
- The taxpayer is elderly or has health issues
- The majority of the hours claimed are for work that does not materially impact operations.
- Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

II. What are the requirements for depreciation and I.R.C. section 179 deductions for the energy equipment?

Depreciation is an annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear, deterioration, or obsolescence of the property. You can depreciate most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment. You also can depreciate certain intangible property, such as patents, copyrights, and computer software.

To be depreciable, the property must meet all the following requirements:

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- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life.
- It must be expected to last more than one year after being placed in service.

A. PROPERTY YOU OWN

To claim depreciation, you must be the owner of the property. You are considered as owning property even if it is subject to a debt. You can depreciate leased property only if you retain incidents of ownership in the property. This means you bear the burden of exhaustion of the capital investment in the property. If you lease property to someone, you generally can depreciate its cost even if the lessee has agreed to preserve, replace, renew, and maintain the property. However, if the lease provides that the lessee is to maintain the property and return to you the same property or its equivalent in value at the expiration of the lease in as good condition and value as when leased, you cannot depreciate the cost of the property.

B. SECTION 179 CONSIDERATIONS

A qualifying taxpayer can choose to treat the cost of certain property as an expense and deduct it in the year the property is placed in service instead of depreciating it over several years. This property is frequently referred to as section 179 property.

The Small Business Jobs Act (SBJA) of 2010 increased the section 179 limitations on expensing of depreciable business assets. Under SBJA, qualifying businesses can expense up to $500,000 of section 179 property for tax years beginning in 2010 and 2011. Without SBJA, the expensing limit would have been $250,000 for 2010 and $25,000 for 2011.

The $500,000 amount provided under the new law is reduced, but not below zero, if the cost of all section 179 property placed in service by the taxpayer during the tax year exceeds $2,000,000.

C. PROPERTY ACQUIRED FOR BUSINESS USE

To qualify for the section 179 deduction, your property must have been acquired for use in your trade or business. Property you acquire only for the production of income, such as investment property, *rental property (if renting property is not your trade or business)*, and property that produces royalties, *does not qualify*. Generally, you cannot claim a section 179 deduction based on the cost of property you lease to someone else.

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This rule does not apply to corporations. However, you can claim a section 179 deduction for the cost of the following property:

1. Property you manufacture or produce and lease to others.
2. Property you purchase and lease to others if both the following tests are met:
   a. The term of the lease (including options to renew) is less than 50% of the property's class life.
   b. For the first 12 months after the property is transferred to the lessee, the total business deductions you are allowed on the property (other than rents and reimbursed amounts) are more than 15% of the rental income from the property.

Unless the above test is met, the Member will not be able to take a section 179 deduction on the contract to lease the equipment to IAS for marketing purposes. However, once the equipment is placed in service, the Member can then take advantage of section 179 deduction.

D. PROPERTY PLACED IN SERVICE

You place property in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use. The example the IRS lists in its article "Overview of Depreciation" is as such:

> Donald Steep bought a machine for his business. The machine was delivered last year. However, it was not installed and operational until this year. It is considered placed in service this year. If the machine had been ready and available for use when it was delivered, it would be considered placed in service last year even if it was not actually used until this year.

III. How can I get a letter from the IRS stating its position on material participation and section 179 deductions?

The IRS will give a letter ruling to a taxpayer in response to a written inquiry, filed prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions. *Rev. Proc. 2010-1 I.R.B.* A letter ruling interprets the tax laws and applies them to

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the taxpayer's specific set of facts. Once issued, a letter ruling may be revoked or modified for a number of reasons.

The service generally only issues letter rulings to the taxpayer directly involved. For example, a taxpayer may not request a letter ruling relating to the tax consequences of a transaction to a customer or a client. The customer or client must make the request for himself.

The cost of a letter ruling is $14,000. If the request involves a personal or business tax issue from a person with gross income of less than $250,000, the fee is reduced to $625. If the taxpayer has a gross income of more than $250,000 but less than $1 million, the fee is then $2,000.

IV. Conclusion

I hope the above adequately answers yours questions. This report has been generated merely to help the members of RaPower3's multi level marketing organization to make an informed decision regarding his tax planning options. I recommend that the individual taxpayer consults his own lawyer and tax professional if he wants professional assurances that this information, and his interpretation of it, is appropriate to his particular situation. I remain available to you should you have further inquiry regarding RawPower3.

Sincerely,
Anderson Law Center, P.C.

Jessica L. Anderson

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