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Recent Tax Court Case on Passive Activity of LLC or LLP Owner

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TWO COURT CASES HOLD THAT LLC INTERESTS SHOULD NOT BE SUBJECT TO THE SAME CONSTRAINTS AS LIMITED PARTNERSHIP INTERESTS FOR PURPOSES OF PASSIVE LOSS RULES

Two recent cases, one from the U.S. Tax Court and the other from the U.S. Court of Federal Claims, have ruled favorably to taxpayers that owners of limited liability companies are not subject to the same restrictions as owners of limited partnership interests in applying the passive activity federal tax rules.

Background: General Rules for Passive Activities. An individual taxpayer's losses from passive activities are not as favorable as ordinary losses because passive activity losses generally may only be deducted against income from passive activities. A net passive activity loss cannot be deducted until a taxpayer disposes of his or her entire interest in the passive activity in a taxable transaction. A passive activity loss is a loss from a trade or business in which the taxpayer owns an interest but does not materially participate.

An individual generally will be treated as materially participating in an activity, and thus not subject to the passive activity loss limitations for such activity, during a year if and only if he or she meets one of the following seven tests:

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual is the only individual participant in the activity for such year;

(3) The individual participates in the activity for more than 100 hours and at least as much as any other individual for such year;

(4) The individual participates in the activity for more than 100 hours and more than 500 hours total in that activity and other "100 hour" activities;

(5) The individual materially participated in the activity for any five out of the last ten taxable years;

(6) The activity is a personal service activity and the individual materially participated in the activity for any three taxable years; or

(7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Losses from real estate are presumptively treated as passive losses unless the taxpayer is a real estate professional, in which case the normal passive activity rules apply.

Special Rules for Limited Partners. An ownership of a limited partnership interest is deemed to be a passive activity unless the limited partner can meet test (1), (5) or (6) above. So, a limited partner is constrained to meeting one of those three tests instead of being able to meet any one of the seven tests that are ordinarily available. However, the limited partner restriction does not apply if an individual owns both a general partnership interest as well as a limited partnership

interest in the same partnership; in such a situation, the individual is allowed to meet any one of the seven tests for material participation with respect to such partnership activity.

Tax Court Ruling. The U.S. Tax Court has issued an opinion finding that taxpayers who held interests in limited liability partnerships ("LLP's") and limited liability companies ("LLC's") and as tenants in common were able to use any of the seven general tests for purposes of determining their "material participation" in the activities. Garnett v. Commissioner, 132 T.C. No. 19 (June 30, 2009). The Court ruled that, although ownership in LLC's and LLP's does constitute ownership of a limited partnership interest within the meaning of such term as used in the passive activity rules, LLC and LLP owners are considered to own both limited and general partner interests for purposes of the passive activity rules. Therefore, an individual LLC or LLP owner is not precluded from using the general tests for material participation as described above.

Although the LLC's and LLP's in the Garnett case were Iowa entities, the Court's ruling should be broad enough to cover LLC's and LLP's in almost all, if not all, states. The holding of the Court was primarily based on the fact that members of most LLC's and LLP's, unlike limited partners in most state law limited partnerships, are not barred by state law from materially participating in the entities' business.

Court of Federal Claims Ruling. The U.S. Court of Federal Claims has issued an opinion holding that a taxpayer who owned an interest in an LLC was able to use any of the seven general tests for purposes the material participation passive activity rules. Thompson v. United States, Fed. Cl., No. 06-211 T, July 20, 2009. The reasoning of the Court in Thompson was that the material participation rules applicable to limited partners do not apply to members of LLC's because those restrictive rules only apply to state law partnerships and an LLC is not a state law partnership.

Conclusion. Although the Courts in Garnett and Thompson did not use identical reasoning in arriving at their respective holdings, the end result is the same: a favorable determination for owners of interests in LLC's and other entities which are not state law limited partnerships that they can use the full range of available material participation tests under the passive activity rules.

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