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Courts Clarify Application of the Passive Loss Rules to LLCs

By: Ezra Dyckman and Seth A. Hagen

In two recent cases, the United States Tax Court and the United States Court of Federal Claims each ruled in favor of the taxpayer that certain interests in limited liability companies ("LLCs") would not constitute limited partnership interests for purposes of applying the passive activity loss limitation rules of Internal Revenue Code section 469. Generally, where an investor holds an interest in an activity through a limited partnership interest, the investor's involvement is presumed to be passive and losses from that activity may only be used to offset income from other passive sources. An investor may rebut this presumption only by satisfying one of three regulatory tests. By ruling that an investment through an LLC should not be treated as presumptively passive, the decisions effectively allow LLC members to establish their active involvement in the activity by meeting one of seven regulatory tests.

Passive Activity Loss Rules

In 1986, Congress enacted Internal Revenue Code section 469 to limit the losses and credits available to taxpayers from "passive" activities. Of motivating concern to Congress was the participation of taxpayers in certain tax shelters. These tax shelters afforded investors the opportunity to reduce or avoid tax liability with respect to their salary or other income by making available deductions and credits potentially in excess of the real economic costs borne by the taxpayer. For example, high income individuals were investing in real estate activities unrelated to their occupations principally to reap tax benefits allotted to those industries. The typical tax shelter would provide these tax benefits to investors despite the fact that the investors lacked a significant interest in the economic performance of the actual activity and were not materially involved in the operations of the activity. To remedy the problem typified by the passive investment in business activities unrelated to the investor's principal occupation, the passive activity rules were enacted to prohibit the offset of deductions in excess of income (i.e., losses) from passive activities against income from other sources such as salary, interest, dividends, gains, and active business income.

Under Code section 469(a)(1), the deductibility of losses from certain passive activities of individual taxpayers (as opposed to, e.g., corporate taxpayers) are disallowed. Passive losses disallowed in one year generally may be carried forward to offset passive income in future years. Upon the ultimate disposition of a taxpayer's interest in a passive activity, previously disallowed losses are generally allowed. A "passive activity" is a trade or business in which the taxpayer does not "materially participate." A taxpayer is considered to "materially participate" in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. Generally, material participation may be established by the taxpayer by meeting one of seven alternative tests described in the Treasury Regulations. Under these alternative tests, an individual can demonstrate material participation if (1) the individual participates in the activity for more than 500 hours during the year, (2) the individual's participation in the activity for the year constitutes substantially all of the participation in such activity of all individuals for such year, (3) the individual participates in the activity for more than 100 hours during the year and such participation is not less than the participation of any other individual for the year, (4) the activity is a "significant participation activity" and the individual's aggregate participation in all significant participation activities for the year exceeds 500 hours, (5) the individual materially participated in the activity for any five years during the 10 preceding years, (6) the activity is a "personal service activity" and the individual materially participates in the activity for any three years preceding the current year, or (7) based on all the facts and circumstances, the individual participates in the activity on a regular, continuous and substantial basis during such year.[1]

***Ezra Dyckman** is a partner in, and **Seth A. Hagen** is an associate of, the law firm of Roberts & Holland LLP.*

The Limited Partner Rule

Certain onerous presumptions apply with respect to the passive loss rules. The focus of this article is on one such presumption whereby, except as otherwise provided by the Treasury Regulations, interests in an activity held in a limited partnership by a limited partner are not treated as interests with respect to which the taxpayer materially participates (the "limited partner rule").[2] There are two exceptions to the limited partner rule. Under the "general partner exception," if the limited partner is also a general partner in the partnership at all times during the year, none of that partner's interest in the partnership is treated as a "limited partnership interest" for purposes of applying the limited partner rule.[3] Under the other exception to the limited partner rule, a limited partner is allowed to demonstrate material participation under the alternative tests numbered 1, 5 or 6, described above. Generally, if a limited partner is involved in real estate activity, the partner may only demonstrate material participation by showing more than 500 hours of participation for the year or by showing material participation in five of the last 10 years. As there is typically no other cause for a limited partner in a real estate activity to track her time and activity, unless an individual is aware she must meet these tests, she may not keep records of her time and activity adequate to substantiate material participation under these tests.

For purposes of the limited partner rule, the Treasury Regulations treat a partnership interest as a limited partnership interest if

(A) Such interest is designated a limited partnership interests in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership.)

Recent Guidance

It had been unclear how limited liability companies (LLCs) treated as partnerships for federal tax purposes were treated for purposes of the limited partner rule. These entities offer liability protection to their members akin to a limited partnership but allow their members greater ability to participate in the management of the entity's business than a limited partnership allows to its limited partners. The two recent cases in the United States Tax Court and the United States Court of Federal Claims examine and shed light on this issue.

In the Tax Court case *Garnett v. Commissioner*,[4] the petitioners held interests in two LLCs. The LLC agreements provided for management by a manager to be selected by a majority vote of the members, but the petitioners were not managers of the LLCs. The IRS contended that losses from the activities performed by the LLCs were presumptively passive with respect to the petitioners because the petitioners' interests in the LLCs were "limited partnership interests" for purposes of the limited partner rule. Petitioners argued that the limited partner rule did not apply both because (i) none of the companies was a limited partnership and (ii) the petitioners should be considered general partners rather than limited partners.

The Tax Court in *Garnett*, while acknowledging that Congress in 1986 did not specifically contemplate LLCs (which then existed only in Wyoming) in drafting the limited partner rule, found to be too narrow the petitioners' argument that the rule could not apply to LLCs because an LLC was not, strictly speaking, a limited partnership. In examining the legislative history of the limited partner rule, the Tax Court found that Congress had considered that the secretary of the treasury would have regulatory authority to treat substantially equivalent entities as limited partnerships for purposes of the limited partner rule. The Tax Court determined that interests in an LLC may be substantially equivalent to an interest in a limited partnership. However, the Court also held that the petitioners' interests in the LLCs were not limited partnership interests because those interests qualified for the general partner exception. Neither the Code nor the Treasury Regulations defined or provided guidance as to what constitutes a "general partner" for purposes of the exception to the limited partner rule; accordingly, the Tax Court looked to the legislative history that set forth the special considerations pertinent to treating limited partnership interests as presumptively passive. One such special consideration was that a limited partner was generally precluded by state law from participating in the partnership's business. Participation in the partnership's business would cause the partner to lose his limited liability protection. Because limited partner status effectively prevents that partner from participating, Congress thought this circumstance precluded the need to examine the facts and circumstances to determine whether the partner materially participated. The Tax Court reasoned that because, in the case of an LLC, participation by a partner with limited liability did not impair the limited liability status of that member, the rationale for presuming the partner's interest to be passive was undercut. Accordingly, as the petitioners were not restricted from participating in the management of the LLCs, the court found the petitioners to be general partners rather than limited partners for purposes of applying the limited partner rule and general partner exception.

In *Thompson v. United States*,[5] the Court of Federal Claims was asked to determine whether a member's interest in an LLC treated as a partnership for federal tax purposes was a limited partnership interest for purposes of the limited partner rule. The court found the fact that taxpayer was a manager and had an ability to control the company significant. In finding that the limited partner rule did not apply to the LLC,

the court determined that an LLC is not substantially equivalent to a limited partnership because an LLC is designed to permit active involvement by their members in the management of the business and therefore it made "little sense" to extend the presumption concerning limited partners' lack of material participation to LLCs. The court went on to decide that even if an LLC were considered to be a limited partnership for purposes of the limited partner rule, the members would be treated as falling within the general partner exception.

Impact of the Decisions

The *Garnett* court held that although an interest in an LLC may constitute an interest in a limited partnership for purposes of the limited partner rule, the general partner exception applies to block the presumption that the partners' involvement in the entity's business is passive. The *Thompson* court held that an interest in an LLC is not an interest in a limited partnership for purposes of the limited partner rule, and, in any event, the members of an LLC qualify for the general partner exception. The courts have made it clear that limited liability is not the touchstone for the presumption of passive activity.

Significantly, the fact that the taxpayers in *Garnett* were not managers of the LLC did not prevent the court from finding that the taxpayers were not limited partners for purposes of applying the limited partner rule. The court apparently reasoned that the limited partner rule is a threshold test designed to stop unnecessary material participation analysis where material participation is not possible. The theoretical but not actual ability of an LLC member to participate in the activity is enough to step past the threshold of the limited partner rule.

At first blush, the holdings of *Garnett* and *Thompson* may seem significant, but before tax practitioners and real estate investors uncork the champagne, closer scrutiny of the cases impact is warranted. The holdings simply allow LLC members to demonstrate material participation via any one of the seven regulatory tests, rather than via only the 500-hours test, the five-out-of-the-last-10-years test, or the personal services test. *Garnett* and *Thompson* do not hold that the LLC members were treated as materially participating; the cases merely open the avenues by which the taxpayers can establish this standard. For example, the *Garnett* and *Thompson* taxpayers may demonstrate material participation by showing that their activity constitutes substantially all of the participation for the activity for the year or by showing that they participated for more than 100 hours and no one else participated more. In addition, the investors may demonstrate material participation by demonstrating regular, continuous and substantial activity. In practice, these additional tests may offer some flexibility, but material participation will often remain an onerous standard to substantiate to the satisfaction of the IRS. In many instances, satisfaction of the 500-hours test, the typical test used for substantiation where the limited partner rule applies, will continue to be easiest to document.

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[1] Treasury Regulation section 1.469-5T(a).

[2] Code section 469(h)(2).

[3] Treasury Regulation section 1.469-5T(e)(3)(ii).

[4] 132 T.C. 19 (2009).

[5] 104 AFTR 2d, 2009-xxxx (Ct. Fed. Cl. 7/20/2009).