

Tax Flash

New Federal tax developments
from Grant Thornton's National Tax Office

2009-05
Aug. 5, 2009

Federal Claims Court rejects IRS position on passive activity rules and allows deduction for LLC losses

The U.S. Court of Federal Claims has joined the Tax Court in rejecting the IRS's application of passive activity loss rules for activities conducted in limited liability businesses, i.e., limited liability companies (LLCs) and limited liability partnerships (LLPs).

Specifically, the Court of Federal Claims has held in *Thompson v. United States* (No. 06-211 T) that a taxpayer's interests in a LLC should not be presumed to be that of a "limited partner" and, thus, subject to more restrictive passive loss rules. The decision follows the recent opinion of the Tax Court in *Garnett v. Commissioner* (132 T.C. No. 19) that similarly rejected the IRS's application of passive loss rules to limited liability businesses.

Generally, passive activity losses can be deducted only against passive activity income, not against other kinds of non-passive ordinary income, e.g., wages. The IRS argued in both cases that interests in the limited liability businesses should be treated as limited partners, i.e., subject to a special rule in Section 469(h)(2).

Section 469 classifies business activities conducted in a partnership as passive or active by applying seven material participation tests set forth in Treas. Reg. Sec. 1.469-5T(a). The special rule under Section 469(h)(2), however, presumes a "limited partner" in a "limited partnership" to be a passive investor. Moreover, not only are losses of limited partners flowing from their limited partnerships presumed to be passive, but limited partners are also allowed to use only three of the seven material participation tests to rebut the presumption.

In *Thompson*, the U.S. Court of Federal Claims ruled in summary judgment that the taxpayer's LLC interests should not be treated as limited partner interests; therefore, the taxpayer should not be presumed passive under the special rule in Section 469(h)(2). The taxpayer was allowed to use all seven material participation tests. Because the IRS had stipulated that the taxpayer would satisfy the material participation requirements if allowed to use all seven tests, the court allowed the taxpayer to claim the loss deduction.

Contact information

Noel Brock
National Tax Office
T 202.861.4104
E Noel.Brock@gt.com

Dustin Stamper
National Tax Office
T 202.861.4144
E Dustin.Stamper@gt.com

www.GrantThornton.com/tax

The U.S. Court of Federal Claims appeared to reach its decision on slightly broader grounds than did the Tax Court in *Garnett*, holding not only that the taxpayer was not a “limited partner” in the LLC (even if the LLC were a “limited partnership”), but also that an entity that is not a limited partnership under state law cannot fall within the Section 469(h)(2) definition of a “limited partnership.” In *Garnett*, the Tax Court likewise held that members of an LLC (and partners in an LLP) are not “limited partners” as that term is defined under state law, but the Tax Court reserved as a possibility that an entity other than a state law “limited partnership” could be treated as a limited partnership for purposes of Section 469(h)(2).

The use of LLCs and LLPs has increased tremendously since the 1990s. Most statutes allow members of an LLC and partners in an LLP to participate in the conduct of the activities of the entity without jeopardizing the member’s or partner’s state law limited liability. The courts seem to recognize that for purposes of the passive activity loss rules, the level of involvement in the conduct of the business is the primary consideration — not whether the member or partner does or does not possess limited liability under state law.

Broader implications

Although these determinations were made for purposes of the passive activity loss rules, and in particular Section 469(h)(2), the decisions could impact other areas of the tax law where a limited partner is treated specially solely because of the limited partner’s status as a limited partner under state law.

What happens now

With both cases decided by courts of general jurisdiction, the IRS may find it more difficult to continue to argue that members of LLCs and partners of LLPs should be treated as state law limited partners and, thus, subject to the more restrictive passive loss rules. The IRS still has time to appeal one or both decisions, and taxpayers should watch to see what action, if any, the IRS takes in response to the two decisions.

Tax professional standards statement

This document supports the marketing of professional services by Grant Thornton LLP. It is not written tax advice directed at the particular facts and circumstances of any person. Persons interested in the subject of this document should contact Grant Thornton or their tax advisor to discuss the potential application of this subject matter to their particular facts and circumstances. Nothing herein shall be construed as imposing a limitation on any person from disclosing the tax treatment or tax structure of any matter addressed. To the extent this document may be considered written tax advice, in accordance with applicable professional regulations, unless expressly stated otherwise, any written advice contained in, forwarded with, or attached to this document is not intended or written by Grant Thornton LLP to be used, and cannot be used, by any person for the purpose of avoiding any penalties that may be imposed under the Internal Revenue Code.

The information contained herein is general in nature and based on authorities that are subject to change. It is not intended and should not be construed as legal, accounting or tax advice or opinion provided by Grant Thornton LLP to the reader. This material may not be applicable to or suitable for specific circumstances or needs and may require consideration of nontax and other tax factors. Contact Grant Thornton LLP or other tax professionals prior to taking any action based upon this information. Grant Thornton LLP assumes no obligation to inform the reader of any changes in tax laws or other factors that could affect information contained herein. No part of this document may be reproduced, retransmitted or otherwise redistributed in any form or by any means, electronic or mechanical, including by photocopying, facsimile transmission, recording, re-keying or using any information storage and retrieval system without written permission from Grant Thornton LLP.