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Say bye-bye to passive activity losses: A possible past-time for LLCs and LLPs

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Limited liability companies (LLCs) and limited liability partnerships (LLPs) are well ingrained as two of the preferred techniques used by estate planning professionals. Both LLCs and LLPs offer significant advantages that many other techniques do not: valuation discounts, retention of control, and tax efficiency. To the delight of those individuals who use LLCs and LLPs in their estate planning work, the perceived tax efficiency of these methods has improved through two recent court cases.

LLPs and LLCs are taxed as partnerships, unless the LLC elects to be taxed as a corporation, which admittedly is rare. This makes LLPs and LLCs "pass-through" entities for federal income tax purposes. In a pass-through entity all profits and losses are passed-through directly to the members at the partnership level, thus avoiding double taxation. The pass-through aspect of these entities also allows members to use losses to offset against their income.

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But the ability to offset is not absolute. The IRS has historically held that LLC and LLP losses are often treated as "passive activity losses." A passive activity is a business activity in which the taxpayer does not "materially participate" I.R.C. § 469. The downside of passive activity losses is that they are of limited value as they can only be used to offset gains from passive activities. This means that passive losses cannot be used to offset wages, interest or dividends. In contrast, active losses are much more flexible as they can be used to offset either active income or passive income.

The view of the Service is that LLC and LLP interests should be characterized as limited partnership interests, meaning that a member's participation could not generally be treated as "material participation" and would be passive and therefore restricted in use. I.R.C. § 469(h)(2). Treas. Reg. § 1.4695T(e)(3)(i) defined how a member can show material participation, but these methods are very restrictive:

> (i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—
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> (A) Such interest is designated a limited partnership interest 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
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> (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).

Fortunately, the ability to use LLCs and LLPs yet avoid the passive activity rules has recently improved. In the case of *Garnett v. Commissioner*, (132 T.C. No. 19 (June 30, 2009)) and the U.S. Court of Federal Claims case of *Thompson v. United States*, (87 Fed. Cl. 728 (July 20, 2009)), the Service's position that interests in an LLP or LLC were limited partnership interests was rejected.

In the case of *Thomson v. United States*, the Court held that an LLC is not a partnership and that the use of the phrase in Treas. Reg. § 1.4695T(e)(3)(i)(B) "under the law of the State in which the partnership is organized" required the entity to be a state law partnership for the limited partnership limitations of Section 469(h)(2) to apply and thus be taxed like a partnership. The significance of this case is that losses passed through to LLC owners will not be treated as automatically passive and thus may be used to offset active income. Though, the LLC members will still be required to prove though that they materially participate in the LLC's activity in order to use any losses against active income.

In the case of *Garnett v. Commissioner*, the IRS disallowed the use of losses from various LLCs and LLPs against other income, arguing that the interests were limited partnership interests. Rejecting the Service's position, the Court found that because the members were not prevented by state law from actively participating in these entities, they were general partners and not limited partners. Consequently, if the members could satisfy one of the seven material participation tests, they would be able to avoid the limitation on passive losses.

These cases provide a member of a LLC or LLP the opportunity to deduct the member's losses in these entities against the member's active income. Nevertheless, caution is still advised as these cases do not completely resolve the issue. Both courts were simply trial courts, so their decisions will not be binding on the Service in other taxpayer disputes if the IRS decides to try this position again. So even though it is unlikely that the Service would resume its previous position, it would be well advised to keep your ear to the ground. ■