



Courts examine nature of LLC, LLP interests

Two recent court cases provide noteworthy guidance on the nature of ownership interests in limited liability companies (LLCs) and limited liability partnerships (LLPs) by treating such interests as “general partner” instead of “limited partner” interests for purposes of applying the passive loss rules under section 469:

- *Garnett v. Commissioner*, 132 T.C. No. 19 (June 30, 2009)
- *James R. Thompson v. United States*, No. 06-211 T (July 20, 2009)

Two recent court cases provide noteworthy guidance on the nature of ownership interests in limited liability companies (LLCs) and limited liability partnerships (LLPs) by treating such interests as “general partner” instead of “limited partner” interests for purposes of applying the passive loss rules under section 469.

In the first, *Garnett v. Commissioner*, 132 T.C. No. 19 (June 30, 2009), the Tax Court determined that a taxpayer’s interests in several LLCs and LLPs were held as general partners and not as limited partners. Because the taxpayer did not hold the LLC and LLP interests as limited partners, section 469(h)(2) — which presumes that a taxpayer does not materially participate with respect to a limited partner’s interest in a partnership — did not apply. Therefore, the general rules for determining whether a taxpayer materially participates must be evaluated to determine if the losses

from the entities were subject to the passive loss limitations.

In the second, *James R. Thompson v. United States*, No. 06-211 T (July 20, 2009), the US Court of Federal Claims, citing *Garnett*, concluded that in determining material participation for an LLC interest a taxpayer may use any of the general rules and is not limited to the three tests that apply to limited partners. Because the parties agreed that the taxpayer materially participated in the LLC business if the general seven tests were applied, the Court held that the taxpayer’s losses arising from an LLC interest were not subject to the general passive activity loss limitation rules under section 469. Therefore, the taxpayer could claim the losses from the LLC interest on his tax return.

Background

Section 469 limits the deductibility of losses from certain passive activities of individual taxpayers. A passive activity generally is a trade or business

in which the taxpayer does not materially participate. In general, a taxpayer materially participates by having regular, continuous, and substantial involvement in the business operations. Treasury Regulation section 1.469-5T provides seven exclusive tests for determining if a taxpayer materially participates in an activity.

Section 469(h)(2) provides that no interest in a partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates. The temporary regulations under section 469 permit a taxpayer to rebut the presumption that a limited partner does not materially participate, but constrain the taxpayer to only three of the seven tests enumerated in Treasury Regulation section 1.469-5T. Furthermore, the regulations provide that if an individual owns both general and limited interests in a partnership, then the individual will be treated as a general partner for purposes of determining material participation.

The legislative history of section 469 explains that a limited partner generally is precluded from participating in the partnership's business under state law. Thus, generally it should not be necessary to examine facts and circumstances to determine if a limited partner materially participates in an activity.

Because LLCs and LLPs generally do not have the same legal limitations on the participation in management as limited partnerships, the treatment of an ownership interest in an LLC or LLP under the passive loss rules has been uncertain. Neither the legislative

history nor the regulations expressly address the treatment of ownership interests in LLCs and LLPs. This is likely because LLCs and LLPs were uncommon at the time the statute was enacted and the regulations were promulgated.

Facts of Garnett Case

In *Garnett*, the Tax Court addressed whether ownership interests in LLPs, LLCs, and tenancies in common are properly treated as limited partnership interests under the passive loss rules of section 469(h)(2). The taxpayer held direct and indirect interests in several LLCs, LLPs, and tenancies in common, all of which were engaged in agricultural businesses, including the production of poultry, eggs, and hogs. During 2000, 2001, and 2002, the taxpayer claimed losses attributable to their ownership interests in these entities. The IRS disallowed those losses as passive activity losses under section 469(a), asserting that the taxpayer did not materially participate in the activities of the business entities.

Although the taxpayer had no personal liability for the debts of the LLCs and LLPs, the taxpayer legally was permitted to participate in the management under state law. The LLP agreements generally provided that each partner would actively participate in the control, management, and direction of the partnership's business. The LLC agreements generally provided that the members would elect a manager who would have the exclusive authority to act for the LLC to conduct the business. The taxpayer was not elected as the managing

member of the LLCs. Furthermore, the K-1s from the LLPs and LLCs referred to the taxpayer as a "limited partner" and "limited liability member," respectively.

The Garnett Tax Court Decision

The Tax Court first considered whether the limitation on limited partners contained in section 469(h)(2) is applicable to interests in LLPs and LLCs. Citing Congressional intent, the Tax Court concluded that section 469(h)(2) can apply to entities that are substantially equivalent to limited partnerships and that some interests in these equivalent entities appropriately are treated as limited partner interests. However, the Tax Court pointed out that the temporary regulations recognize that a limited partnership interest will not be treated as such if the general partner exception applies. As a result, the Tax Court analyzed whether the general partner exception applies to LLCs and LLPs.

In making its determination, the Tax Court referred to *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Or. 2000), in which a district court held that section 469(h)(2) does not apply to a member of an LLC formed under Oregon law. Because members of LLCs and LLPs can participate in management without losing limited liability under state law, the Tax Court concluded that it cannot be presumed that members of LLCs and LLPs do not materially participate in the business. Instead, it is necessary to examine the taxpayer's facts and circumstances to ascertain the nature and extent of the taxpayer's participation.

Departing from the conventional concepts of “limited partners” and “general partners,” the Tax Court concluded that LLC and LLP members more appropriately are treated as general partners for purposes of section 469(h)(2). Furthermore, the Tax Court concluded that the specific LLP and LLC interests were not subject to the rules of section 469(h)(2) because the ownership interests in the LLPs and LLCs are excepted from classification as “limited partnership interests” by operation of the general partner exception under the temporary regulations.

Facts of the Thompson Court of Claims Case

Mr. Thompson directly held a 99 percent interest in Mountain Air Charter, a Texas LLC, while indirectly owning the other one percent through an S corporation. Mr. Thompson was also the sole manager of the LLC, which was treated as a partnership for US federal income tax purposes.

The taxpayer claimed losses resulting from Mountain Air on his personal 2002 and 2003 federal tax returns. The IRS disallowed those losses under the passive activity rules because the taxpayer lacked material participation in the LLC’s business based on the three tests provided for limited partner interests under Treasury Regulation section 1.469–5T. Both parties agreed that if the seven general tests for determining material participation were applied, then Thompson would have been considered to material participate in the LLC business and thus the

passive activity limitations would not apply.

The Thompson Court of Claims Decision

The government’s simple assertion in the case was that Thompson’s interest in the LLC had to be a limited partnership interest because the entity offered limited liability to its members and was taxed as a partnership.

But the court found plenty in the form of the entity chosen to reject the government’s arguments. The court noted that the language of Treasury Regulation section 1.469–5T(e)(3) clearly indicates that, for there to be a limited partnership interest, the entity must be “a partnership under state law —not merely taxed as such under the Code.” Thus, in the face of such an unambiguous expression, when the interest at issue is not in a state law partnership, the temporary regulations cannot be applied.

Referring back to section 469(h)(2), on which the temporary regulations are based, the court said the statute requires that the “taxpayer must actually be a limited partner.” Language matters, and the fact that Mountain Air is a “member” of an LLC rather than a “limited partner,” places the taxpayer outside the scope of the temporary regulations for limited partner interests. Moreover, the court found that the general partner exception of Treasury Regulation section 1.469–5T(e)(3)(ii) could be applied to undermine the IRS’s theory that Thompson’s interest was a limited partner interest.

Because Thompson was both a member and manager of Mountain Air, he would have been treated as a general partner if the LLC was a limited partnership.

The court ruled in favor of Thompson providing that he may demonstrate material participation in Mountain Air by applying all seven tests under Treasury Regulation section 1.469–5T(a). The court noted that its holding was in accordance with the *Garnett* and *Gregg* cases referred to above. The parties agreed that section 469 did not limit Thompson’s share of Mountain Air’s losses if he did not hold a limited partnership interest. Therefore, the court ruled that Thompson’s share of losses allowed on his individual return were not limited under section 469.

Observations: Both court cases represent taxpayer-favorable rulings and undermine the IRS’s ability to constrain interest holders from determining material participation in LLCs and LLPs to the prescribed three tests for limited partners. Both rulings clarify that it is not only the liability status of a member for debts of the entity but also the ability of the member to participate in the management of the entity that counts in determining the application of section 469.

Taxpayers that hold interests in LLCs and LLPs and previously presumed that their interests were subject to the passive loss rules should reassess their positions by going through all seven tests under Treasury Regulation section 1.469–5T(a) instead of the three

tests of Treasury Regulation section 1.469-5T(e)(2) that apply to limited partners. Some taxpayers could potentially recharacterize their passive losses as active and offset ordinary income. Refund claims for prior periods may also be in order.

Although the issue in *Garnett* and *Thompson* involved the passive activity loss rules of Section 469, the decisions may have an impact beyond section 469. Other code sections that provide for different treatment of general and limited partners include, among others, sections 736 and 1402(a)(13). Under the latter, except for guaranteed payments for services, a limited partner's distributive share of partnership income is generally excluded from the self-employment tax base. Taxpayers who relied upon the limited liability of an LLC member as support for treating an LLC interest as a limited partner interest for purposes of section 1402(a) (13) should evaluate, based on their specific facts and circumstances, how the analysis in these decisions may impact such position.

The specialists in PwC's Personal Financial Services group and Mergers and Acquisition group may assist you in understanding passive activities rules and other planning strategies – contact Personal Financial Services leader Rich Kohan at 617-530-7461 or others listed below to discuss tailored options.

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