

CLIENT REPORT: Guidance on LLC/PAL Rules Interaction

Dear Client:

As a member of a limited liability company (LLC), I would like to bring your attention to a recent decision by the Federal Court of Claims that may be of interest to you. The court in the case of *Thompson v. U.S.*, July 20, 2009, held that an LLC member's interest is not the equivalent to a limited partnership interest for purposes of the passive activity loss rules.

According to the IRS, members of LLCs and limited liability partnerships (LLP) should be treated like limited partnerships under the passive loss rules. In general, an individual who holds a limited partnership interest is not considered to have materially participated in any partnership activity. The effect of this rule is that an individual's limited partnership interests are treated as interests in a passive activity without regard to the partner's participation (unless the partner satisfies the 500 hour and certain other tests). Thus, for purposes of passive activity loss rules, the IRS will treat LLC members as limited partners even if the member is a member-manager.

This is important because unless the limited partner can demonstrate his material participation, the Tax Code will deem his or her share of the LLC's losses to be a "passive activity" loss rather than an ordinary loss, which are less advantageous than ordinary losses because they may only offset passive activity income.

In the case before the court, the taxpayer had organized the LLC, holding a 99 percent member interest and indirectly holding the remaining one percent through an S corporation. The LLC was organized under state law as an LLC, not as a limited partnership. The taxpayer was the LLC's only designated manager. The LLC was treated as a partnership for tax purposes. He claimed the LLC's losses on his tax returns as ordinary losses. The IRS concluded that the taxpayer did not materially participate in the LLC's business and disallowed his claimed losses. Since the taxpayer in the case enjoyed limited liability as an LLC member, the IRS determined that his interest was identical to a limited partnership interest and treated his share of losses as passive activity losses.

According to the court, the LLC was not substantially equivalent to a limited partnership. Unlike a limited partnership, an LLC allows all members to participate in the business without the loss of limited liability.

The Federal Court of Claims' decision came shortly after the Tax Court ruled for a taxpayer in a similar case (*Garnett* , 132 TC No. 19). According to Tax Court in *Garnett* , limited liability alone is not sufficient to qualify interests as limited partnerships. The taxpayers were not presumed to have failed to materially participate under the passive activity loss prohibition.

If you have questions about the passive activity loss rules and their application to your member or partnership interest, please contact our office. We will update on any developments in this area.

Sincerely yours,

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