

## CLIENT ACTION ALERT

### LLC and LLP Investors May Be Able To Treat Entities' Income and Losses As Non-Passive

On June 30, 2009 the United States Tax Court issued a decision (*Paul D. Garnett, et ux. v. Commissioner*, 132 T.C. No. 19) which strengthens tax positions and may create tax benefits for entrepreneurs and other investors in limited liability companies (LLCs) and limited liability partnerships (LLPs).

The longstanding position of the Internal Revenue Service (the IRS) has been that interests in LLCs and LLPs should be considered interests in limited partnerships and that, consequently, members in LLCs and partners in LLPs should be treated as limited partners. The IRS generally presumes that any income or losses allocated to a limited partner by a limited partnership are passive and, therefore, the member's or partner's ability to use any such losses to offset other income for federal income tax purposes is subject to the passive loss limitation rules contained in the Internal Revenue Code. In *Garnett*, the Tax Court rejected this presumption. Thus, members of LLCs and partners in LLPs may now be able to treat income and losses from those entities as active if the holder of the LLC or LLP interest is actively engaged in the entity's business.

An interest holder in an LLC or an LLP can now establish that he or she is entitled to treat losses and income from such entity as non-passive if he or she is regularly, continuously and substantially involved in the LLC or LLP's business operations. A person generally must meet at least one of the following seven tests to demonstrate this material participation:

1. The person engages in the activity for more than 500 hours during the year
2. The person's participation in the activity for the year is substantially all of the participation in the activity by all individuals for the year (i.e., no one else participates in the activity)
3. The person engages in the activity for more than 100 hours during the year, and his or her participation is not less than any other individual's for the year
4. The activity is a "significant" participation activity for the year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours
5. The person materially participated in the activity for any 5 years (whether or not consecutive) during the immediately preceding 10 years
6. The individual materially participated in the activity for any 3 preceding years (whether or not consecutive) if the activity is a "personal service activity"
7. The person engages in the activity on a "regular, continuous, and substantial basis" during the year

In *Garnett*, the Tax Court held that authority to bind an LLC or LLP is not required to demonstrate material participation. *Garnett* may therefore benefit members of both member-and manager-managed LLCs.

Following *Garnett* we recommend that all LLC and LLP investors consult with their tax advisors to ascertain whether they are able to establish material participation. In our experience, many entrepreneurs and start-up investors invest in and provide services to one or more LLCs and may maintain another job. Those that can establish material participation may be able to offset losses from one venture against income from another venture or from employment. In addition, they may be able to use losses to offset income not only in 2009, but may also be able to carry back such losses to prior tax years for which tax returns may be amended.

It should be noted, however, that *Garnett* does not affect the determination of whether income or losses are passive with respect to S corporations and their shareholders, or limited partnerships and their limited partners. Further, while a Tax Court decision is persuasive authority, the IRS is not bound by the decision for other taxpayers. The IRS may even choose to appeal *Garnett*.

\* \* \* \* \*

Please contact either	
<b>William E. Turner II</b> ☎ 312.629.7337	<b>Jeffrey S. Shamberg</b> ☎ 312.629.7381
or another member of the firm, if you have any questions or would like additional information concerning these issues	

This Client Action Alert has been published by the Corporate and Securities Group of the law firm of Barack Ferrazzano Kirschbaum & Nagelberg LLP, 200 West Madison Street, Suite 3900, Chicago, Illinois 60606, (312) 984-3100, as a general source of information and does not constitute an opinion or legal advice and does not create an attorney-client relationship with readers.

***IRS Circular 230 Disclosure*** – Nothing contained herein is intended to, or may be used for, the avoidance of tax or penalties or for promoting any entity, investment or arrangement to any taxpayer.