New Tax Savings Opportunity

Joel C. Farrar
Foster Swift Business & Corporate Law Update
October 2009

A recent case decided by the United States Tax Court might help investors in limited liability partnerships (LLPs) and limited liability companies (LLCs) to deduct losses incurred by the LLPs and LLCs against income from other sources. This could result in large tax savings for entrepreneurs who actively manage their businesses and have incurred losses in recent tax years.

This tax opportunity stems from the "passive activity loss" rules found in Section 469 of the Internal Revenue Code. The "passive activity loss" rules generally prohibit an investor who does not materially participate in the management of the investment from deducting losses that the investor recognizes from the investment ("passive activity losses") against income that the investor earns from unrelated activities in which the investor materially participates. A special rule presumes that losses incurred by a "limited partner" in a "limited partnership" are "passive activity losses," subject to narrow exceptions. The Internal Revenue Service ("IRS") has long argued that an investor's interest in an LLP or LLC is a "limited partnership interest" and, therefore, that the investor generally cannot deduct losses incurred by the LLP or LLC against the investor's other "active income," even if the investor materially participates in the management of the LLP or LLC.

In *Garnett v. Commissioner*, however, the U.S. Tax Court sided with investors and held that, at least under Iowa's law, an investor's interest in an LLP or LLC is not a "limited partnership interest," primarily since investors are, under Iowa law, permitted to participate in the management of the entities. Resultantly, investors in Iowa LLPs and LLCs, and possibly in Michigan LLPs and LLCs, that materially participate in the management of the LLP or LLC might be able to successfully deduct losses incurred by the LLPs and LLCs in 2009, or in earlier tax years, against their "active income" from other sources.

CONTACT
Joel C. Farrar
P: 517.371.8305
E: jfarrar@fosterswift.com

AUTHORS/ CONTRIBUTORS
Joel C. Farrar

PRACTICE AREAS
Business Law
Federal Taxation
Tax Law