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New Cases Give LLC Owners More Avenues to Avoid the Passive Activity Loss Limitations

Two recent cases have given members of an LLC greater ability to avoid the passive activity loss limitations. Under Garnett, decided by the Tax Court in June, and now Thompson, decided July 20 by the Court of Federal Claims, a member of an LLC cannot be automatically treated as a "limited partner" under the passive loss regulations.

Under those regulations, there are seven possible ways a taxpayer can establish that he is "materially participating" in an activity, such that his share of the losses would not be treated as "passive" and therefore could be used to offset nonpassive income (such as salary or portfolio income). However, "limited partners" are presumed not to be materially participating, and only three of the seven tests are available to overcome this presumption. The portion of the regulations to which the courts objected defines a "limited partner" as including any owner of a partnership (including an LLC that is taxed as a partnership) that has limited liability; and of course all LLC members have limited liability, regardless of the extent to which they participate in management.

These cases do not open the door for all LLC members to deduct what otherwise would be passive losses, but they do help those members who meet one of the four tests that are not available to "limited partners."

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