Garnett v. Commissioner, 132 T. C. 368 (U. S. Tax Court 2009)

In Garnett v. Commissioner, the U. S. Tax Court ruled that interests in limited liability partnerships (LLPs) and limited liability companies (LLCs) are not automatically subject to the passive activity loss limitations applicable to limited partners under IRC § 469(h)(2). The decision clarified that LLP and LLC members are not presumptively passive and must be evaluated under general material participation tests, impacting how losses from such entities are treated for tax purposes.

Parties

Paul D. Garnett and Alicia Garnett, Petitioners, filed a petition against the Commissioner of Internal Revenue, Respondent, in the U. S. Tax Court. They were represented by Jeffrey D. Toberer and Donald P. Dworak, while J. Anthony Hoefer represented the Respondent.

Facts

Paul and Alicia Garnett owned interests in seven limited liability partnerships (LLPs), two limited liability companies (LLCs), and two tenancies in common, primarily engaged in agribusiness operations. The Garnetts held most of their interests indirectly through five separate holding LLCs. The LLPs and LLCs reported income and losses on Forms 1065, and on Schedules K-1, they identified the Garnetts or the holding LLCs as limited partners or LLC members. The LLP agreements generally allowed partners to participate actively in management, while the LLC agreements provided for management by a manager selected by majority vote of the members. The tenancies in common were reported as partnerships for tax purposes, with one identified as a general partner and the other as a limited partner on Schedules K-1.

Procedural History

The Garnetts filed a motion for partial summary judgment, seeking a ruling that their interests in the LLPs, LLCs, and tenancies in common were not subject to the passive activity loss limitations under IRC § 469(h)(2). The Commissioner filed a cross-motion for partial summary judgment, arguing that the Garnetts' interests should be treated as limited partnership interests under the temporary regulations. The Tax Court granted the Garnetts' motion and denied the Commissioner's motion, holding that the interests were not subject to the special rule of IRC § 469(h)(2).

Issue(s)

Whether the Garnetts' interests in the LLPs, LLCs, and tenancies in common should be treated as interests in a limited partnership as a limited partner under IRC § 469(h)(2), thereby subjecting them to the passive activity loss limitations?

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Rule(s) of Law

IRC § 469(h)(2) provides that "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates," except as provided in regulations. Temporary regulations under § 1. 469-5T(e) define a "limited partnership interest" and provide exceptions, including that an interest shall not be treated as a limited partnership interest if the individual is a general partner at all times during the partnership's taxable year.

Holding

The Tax Court held that the Garnetts' interests in the LLPs and LLCs were not subject to the passive activity loss limitations under IRC § 469(h)(2) because they did not hold their interests as limited partners. The court further held that the Garnetts' interests in the tenancies in common were also not subject to the rule, as they were not interests in limited partnerships.

Reasoning

The court reasoned that the legislative intent behind IRC § 469(h)(2) was to presume that limited partners do not materially participate in the business due to statutory restrictions on their involvement. However, members of LLPs and LLCs are not similarly restricted by state law, necessitating a factual inquiry into their participation under the general material participation tests. The court applied the temporary regulations and found that the Garnetts' interests in the LLPs and LLCs should be treated as general partner interests, thus falling under the general partner exception in § 1. 469-5T(e)(3)(ii). The court also noted that the tenancies in common were not limited partnerships, and the Garnetts' interests therein were not designated as limited partnership interests. The court rejected the Commissioner's argument that the Garnetts' limited liability status alone should determine their interests as limited partnership interests, emphasizing the need for a broader interpretation that aligns with the legislative purpose of § 469(h)(2).

Disposition

The Tax Court granted the Garnetts' motion for partial summary judgment and denied the Commissioner's cross-motion, holding that the Garnetts' interests in the LLPs, LLCs, and tenancies in common were not subject to the passive activity loss limitations under IRC § 469(h)(2).

Significance/Impact

The decision in Garnett v. Commissioner has significant implications for the tax treatment of losses from LLPs and LLCs. It clarifies that members of such entities are not automatically subject to the passive activity loss limitations applicable to limited partners, requiring an analysis of their material participation under the general tests. This ruling may influence how taxpayers report and claim losses from

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similar entities and could lead to further scrutiny of the temporary regulations governing the application of IRC § 469(h)(2). The decision also underscores the need for the IRS to address the treatment of LLPs and LLCs in final regulations, given the evolving nature of business entities and their tax implications.

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