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Tax Court Rules Against IRS and Increases Deductibility of Business Losses

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On June 30th, the U.S. Tax Court ruled against the IRS and in favor of various small business owners by expanding the deductibility of business losses from businesses organized as limited liability companies ("LLCs") and limited liability partnerships ("LLPs"). The ruling particularly benefits people who are active owners of LLCs or LLPs but also have income from other sources.

The taxpayers in this case were Nebraska farmers who owned partial interests in various LLCs and LLPs and were active in operating the various companies. The companies generated losses, and the taxpayers deducted those losses each year. The IRS argued the losses could only be deducted against the future income of the businesses, not against the taxpayers' ordinary income in the year the losses occurred.

Passive business losses are only deductible against the business's future income. In most cases, courts will analyze the taxpayer's involvement in the business to determine if the business losses are passive or active. Under the Internal Revenue Code, losses from "limited partnership interests" are passive by definition. The IRS unsuccessfully argued that interests in LLCs and LLPs should also fall under this definition. The Court ruled instead that the losses from LLCs and LLPs are passive only if the owner does not materially participate in the business.

How much do you need to participate in an LLC or LLP to be able to enjoy this deduction? Material participation generally means that, during the tax year, you did one of the following:

- Spent at least 500 hours on the business;
- Spent at least 100 hours on the business, which was more time than any other participant;
- Spent at least 100 hours on the business and at least 100 hours on other businesses, such that the total time spent on your "100-hour" businesses is more than 500 hours;
- Were the only participant in the business; or
- Materially participated in the business in 5 of the last 10 years.

Suppose a husband has a high salary job as an engineer and his wife is a partial owner and part-time worker at a gift shop organized as an LLC with business losses this year. Under this new ruling, the losses from the wife's gift shop can be used as a deduction against husband's salary, investment income, or many other types of income.

If you or your spouse is an owner and active participant in an LLC or LLP with losses this year, please contact us to see if you can take advantage of this ruling to reduce your personal tax bill in 2009.

The case is *Garnett v. Commissioner* 132 T.C. No. 19. The opinion can be found at:

http://www.ustaxcourt.gov/InOpHistoric/garnett.TC.WPD.pdf.

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