DO THE PASSIVE ACTIVITY LOSS RULES IMPACT THE CHOICE OF A FAMILY LIMITED PARTNERSHIP VERSUS A FAMILY LIMITED LIABILITY COMPANY FOR ESTATE PLANNING DISCOUNT PURPOSES?[1]

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INTRODUCTION

A family limited partnership (FLP) and a family limited liability company (FLLC) are two entity choices frequently used by estate planners to achieve federal estate tax ("estate tax") savings.[4] While many considerations impact the choice of a FLP versus a FLLC,[5] one factor that probably escapes consideration by many practitioners is the impact of the passive activity loss (PAL) rules for Federal income tax ("income tax") purposes on that choice.

The rules for determining whether a limited partnership interest, including one in a FLP, is subject to the PAL rules have always been fairly clear. Until recently, that was not the case for a membership interest in a LLC, including one in a FLLC. Fortunately, two recent cases, *P.D. Garnett*,[6] and *J.R. Thompson*[7] shed considerable light on and, hopefully, bring some certainty to this issue. For all practical purposes, limited partners in a FLP designed to achieve estate tax savings will be unable to establish material participation in the activities of the FLP. However, based on *Garnett* and *Thompson*, members in a FLLC designed for the same purpose have a greater ability to establish material participation in the activities of the FLLC and, as such, may be able to currently deduct losses flowing from the FLLC as ordinary losses against ordinary income.[8] Such ability, however, likely depends on whether the provisions governing the management of the FLLC can be structured in a particular, novel way under state law.

This article initially provides a brief overview of the PAL rules. Then, it discusses the impact of the *Garnett* and *Thompson* decisions on the application of the PAL rules to members of a FLLC.

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[4] Their use can also be supported by numerous non-tax justifications based on behavioral economics and portfolio management concepts. For a detailed discussion of these justifications in the context of investment FLPs, see Louis S. Harrison & John M. Janiga, 40 *Real Property, Probate and Trust Journal* 117-147 (2005).
[5] For a discussion of two such issues – the appearance of the entity, including its name, to the IRS, and the potential application of IRC Section 2704(b) of chapter 14, see Louis S. Harrison & John M. Janiga, "Finding the Pot of Gold at the End of the Family Limited Partnership Rainbow," ___ *Journal of Passthrough Entities* ___ (March/April 2010).
[6] 132 T.C. No. 19.
[7] 104 AFTR 2d 2009-5381 (Fed. Cl. Ct., 2009).
[8] The deductibility of the losses may be impacted by other loss limitation provisions such as the at-risk rules under IRC Section 465 and the net capital loss limitation under IRC Section 1211(b). The discussion in this article assumes that such provisions either do not apply or, if applicable, will not serve prevent deductibility so long as the losses are otherwise deductible under the PAL rules.

Finally, we address whether this impacts the choice of using a FLP versus a FLLC for estate tax discount planning ("discount planning"). [9]

PAL RULES: IN A NUTSHELL

Internal Revenue Code (IRC) Section 469 generally provides that a taxpayer may deduct a net loss incurred in a passive activity only to the extent of net income from all of the taxpayer's passive activities.[10] Any excess, the net passive loss (NPL), cannot be currently deducted against the taxpayer's active or portfolio income. Instead, the NPL is suspended and carried forward indefinitely to future years to offset passive income generated in those years.[11] Otherwise, the NPL is deductible only when the taxpayer disposes of his or her entire interest in the activity. At that point, all current and suspended NPLs related to the activity may be deducted versus active or portfolio income, or both.[12]

Also, under IRC Section 469, the use of credits arising from passive activities ("passive credits") is limited. Specifically, a taxpayer generally may offset passive credits only against regular tax attributable to passive income. This amount is computed by comparing the tax on all income, including passive income, with the tax on all income, excluding passive income.[13] Any currently useable passive credit is carried forward indefinitely, similar to NPLs.[14] However, unlike NPLs, passive credits are only useable on disposition of the activity if there is sufficient tax on passive income to absorb them.[15] If not, the passive credits are lost forever.

The PAL rules apply to any passive activity, defined as: (1) any trade or business or income-producing activity in which the taxpayer does not materially participate, or (2) any rental activity (subject to certain exceptions[16]), regardless of whether the taxpayers materially participates in such activity.[17] Further, the rules apply to individuals, estates, trusts, personal service corporations, and closely held C corporations.[18] If a taxpayer subject to the PAL rules owns an interest in a passthrough entity, like a FLLP or FLLC, the taxpayer must assess whether the interest in the entity is an interest in a passive activity. If so, then the taxpayer's share of income or loss from the entity constitutes passive income or passive loss, respectfully.

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[9] FLPs also can be used to transfer limited partnership interests during life at discounted values. A similar strategy is available for membership interests in a FLLC. While creative and effective strategies are available for achieving these transfers, this article focuses on the use of these entities for estate tax discounts (i.e., when the majority of the equity in the FLP or FLLC is retained by the decedent until the decedent's death in an attempt to obtain a discount for valuation purposes on those retained interests in the decedent's estate.

[10] See IRC Section 469(a)(1)(A) (disallowing a "passive activity loss"), and IRC Section 469(d)(1) (defining the term "passive activity loss" as the amount by which the aggregate losses from all passive activities for the year exceed the aggregate income from all passive activities for such year).

[11] IRC Section 469(b).

[12] IRC Section 469(g).

[13] IRC Section 469(a)(1)(b), (d)(2).

[14] IRC Section 469(b).

[15] IRC Section 469(d)(2).

[16] See Temp. Reg. Section 1.469-1T(e)(3)(ii).

[17] IRC Section 469(c)(1). The term "passive activity" does not include any working interest in oil or gas property that the taxpayers holds directly or through an entity that does not limit the taxpayer's liability with respect to that interest irrespective of whether the taxpayer materially participates in such activity. IRC Section 469(c)(3). Also, although the IRC defines rental activities as passive activities, several exceptions allows losses from certain real estate rental activities to offset active or portfolio income. See IRC Section 469(c)(7), (i).

[18] IRC Section 469(a)(2).

IRC Section 469(h)(1) provides that a taxpayer materially participates in an activity if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial. Temporary regulations under IRC Section 469 identify seven tests for assessing whether an individual materially participates in an activity.[19] A taxpayer can meet any one of these tests to be considered materially participating. The tests are:

1. Does the individual participate in the activity for more than 500 hours during the year?
2. Does the individual's participation in the activity for the taxable year constitute substantially all of the participation in the activity of all individuals for the year?
3. Does the individual participate in the activity for more than 100 hours during the year, and is the individual's participation in the activity for the year not less than the participation of any other individual for the year?
4. Is the activity a significant participation activity for the taxable year, and does the individual's aggregate participation in all significant participation activities during the year exceed 500 hours?
5. Did the individual materially participate in the activity for any 5 taxable years during the 10 taxable years that immediately precede the taxable year?
6. Is the activity a personal service activity, and did the individual materially participate in the activity for any three preceding taxable years?
7. Based on all of the facts and circumstances, did the individual participate in the activity on a regular, continuous, and substantial basis during the year?

A general partner may qualify as materially participating by meeting any of the seven tests. However, under IRC Section 469(h)(2), a limited partner in a limited partnership is prohibited from being considered a material participant in the limited partnership except as provided in the regulations. Under IRC Section 469's temporary regulations, a limited partner generally is not considered materially participating unless he or she meets Tests 1, 5, or 6 above.[20] Thus, absent material participation in the activity in prior years (i.e., Tests 5 or 6 are met), a taxpayer who participates for less than 500 hours in the tax year in an activity in which the taxpayer is a limited partner will flunk Test 1. In such case, the limited partner would not be viewed as materially participating; consequently, losses from such activity would be subject to the PAL rules.

The IRC Section 469 temporary regulations also contain a "general partner exception." Under this exception, if a general partner is also a limited partner in the same limited partnership both interests are treated as a general partnership interest.[21]

IMPORT OF GARNETT AND THOMPSON

Numerous provisions of the IRC and regulations provide different results for the same type of transaction depending on whether the taxpayer is a general partner or a limited partner. A particularly vexing issue is whether a member of a limited liability company (LLC), including a FLLC, is a general partner or limited partner for a particular provision of the IRC. Although the answer is still far from clear for many such provisions, the decisions in *Garnett* by the U.S. Tax Court and *Thompson* by the U.S. Court of Federal Claims appear to have brought some clarity and substantial authority to the issue of how the PAL rules apply to a member in a LLC, including a FLLC.

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[19] Temp. Reg. Section 1.469-5T(a). Although issued in 1988, these "Temporary" Regulations have remained unchanged and are still in effect.
[20] Temp. Reg. Section 1.469-5T(e)(2).
[21] Temp. Reg. Section 1.469-5T(e)(3)(ii).

Prior to *Garnett* and *Thompson*, the U.S. District Court for the District of Oregon decided *S.A. Gregg*,[22] a case in which the court concluded that an LLC member was a general - not limited - partner for purposes of determining whether the LLC member materially participated in the LLC's business. Besides the fact that this conclusion was in dicta, the case has limited precedential value because it only applies to district courts in Oregon.

In contrast, the issue of whether a member of a LLC was a general or limited partner for purposes of the material participation regulations was central to the court's determinations in *Garnett* and *Thompson*. Further, *Garnett* and *Thompson* were decided by courts with national jurisdiction for tax cases,[23] thereby providing significant precedent for all taxpayers subject to income tax.

In both *Garnett* and *Thompson*, one of the key issues was whether members of an LLC should be treated as limited partners for purposes of the PAL rules.[24] If so, the members would not be viewed as materially participating unless they met the more stringent material participation tests (i.e., Tests 1, 5, or 6).

In both cases, the government contended that the limited liability[25] enjoyed by LLC members was sufficient to treat such members as limited partners for purposes of IRC Section 469(h)(2) and its related regulations. The *Garnett* court, in rejecting that contention, concluded that the legislative history to IRC Section 469(h)(2) reflected Congress' belief that limited partners were legally precluded from participating in the partnership's activities if they sought to maintain limited liability. Because LLC members are not so precluded, the court concluded that the taxpayers held their LLC membership interest as "general partners" within the meaning of the IRC Section 469 temporary regulations.

The *Thompson* court generally agreed with the *Garnett* analysis.[26] Additionally, it raised several other reasons to support its conclusion that a member of a LLC should be treated as a general partner in applying the material participation tests.[27]

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[22] S.A. Gregg, DC-OR, 2001-1 USTC ¶ 50,169, 186 Fsupp2d 1123.

[23] The U.S. Tax Court is a court of national jurisdiction for tax deficiency cases, while the U.S. Court of Federal Claim is a court with national jurisdiction for tax refund cases.

[24] In *Garnett*, the taxpayers also owned interests in limited liability partnerships and tenancy-in-common interests, which were treated by the court in the same manner as the LLC membership interests. In *Thompson*, only a LLC interest was in question, held 99 percent directly by the taxpayer and held 1 percent through an S corporation.

[25] In this context and as used throughout this article, the reference to "limited liability" is a limitation provided by statute (i.e., by operation of state law), not by contract or other means.

[26] The *Garnett* and *Thompson* decisions differ in one significant respect. As stated by one commentator: "The *Garnett* court invited the Treasury to issue regulations concerning the status of an LLP or LLC member as a general or limited partner for purposes of [IRC Section] 469(h)(2). In contrast, the *Thompson* court was silent as to the Treasury's authority to issue such regulations. The *Thompson* court, however[,] interpreted the legislative history of [IRC Section] 469(h)(2) to mean that the Treasury only has the authority to issue regulations providing rules denying taxpayers limited partner status when such taxpayers seek to be classified as limited partners for tax sheltering purposes." Kalinka, "*Garnett* and *Thompson*: Tax Court Holds LLC and LLP Members are General Partners Under Code Sec. 469(h)(2); U.S. Court of Federal Claims Agrees, Part I – The Opinions and Their Value to Taxpayers," ___ *Taxes-The Tax Magazine* 5-16 and 60, at 12.

[27] First, it noted that an LLC is not a limited partnership. Limited partnership must have two types of owners: general partners, who may participate in the management of the partnership but are personally liable for its debts, and limited partners, who have limited liability but are unable to participate in management without potentially losing such limitation. LLC members have no such dichotomy: all members enjoy limited liability and may freely participate in the management of the LLC without losing

Taken together, *Garnett* and *Thompson* provide substantial authority for members in an LLC to treat their interests as general partnership interests for purposes of IRC Section 469 and its related regulations. Consequently, LLC members may satisfy any one of the seven tests in order to establish material participation and, thus, avoid application of the PAL rules.

<u>IMPLICATIONS ON ENTITY SELECTION: FLP v. FLLC</u>

Two of the most commonly used entities for effectuating discount planning are the FLP and FLLC. While the structure of FLPs and FLLCs may be geared towards estate tax savings, income tax considerations should not be ignored. One such consideration, as suggested by *Garnett* and *Thompson*, should be the potential application of the PAL rules.

On surface, as an LLC is generally taxed as a partnership under the IRC,[28] practitioners often conclude that there should be no difference between a FLP and a FLLC from an income tax standpoint, including with respect to PALs. However, depending on how the FLP or FLLC is structured that may not be correct.

The FLP is designed to reduce the value of the decedent's immediate interest in the FLP to less than the value the decedent would receive on liquidation of the FLP. It does so by making the limited partnership interests in the FLP illiquid and, therefore, entitled to a discount. To the extent that the decedent retains limited partnership interests at death without a corresponding controlling general partnership interest, the argument is that these limited partnership interests are worth less than their *pro rata* liquidation value.

Structurally, the majority of the equity in the FLP is represented by the limited partnership interests. For example, ninety percent or more of the equity in the partnership could be represented by limited partnership interests. The minority of the equity is represented by the general partnership interests, typically less than ten percent.

The general partners control the partnership through their ability to elect managing partners. The managing partners decide on, when, and if to make partnership distributions and whether to liquidate the partnership, sell assets, or merge the partnership with a third party. The limited partners are entitled merely to distributions from the partnership, which may be sporadic or may even first arise upon sale or liquidation.

Given this distinction, multiple arguments support the notion that the limited partnership interests are worth less than their *pro rata* liquidation value. First, the limited partners have no control, which among many other things, precludes them from obtaining the underlying value of the assets in the partnership. For example, the limited partner cannot withdraw from the partnership and obtain fair market value; has no put or similar rights; and cannot force any annual cash distribution. Second, the limited partners may be unable to sell their interests for value even close to their *pro rata* liquidation value in the partnership because a hypothetical willing buyer would

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such limitation. Second, the court concluded that IRC Section 469's statutory and regulatory framework did not support a dividing line between general and limited partnerships interests based on limited liability, but rather one focusing on material participation in an activity. Third, the legislative history to IRC Section did not demonstrate that Congress cared about a taxpayer's level of liability.

[28] Pursuant to the check-the-box regulations, unincorporated eligible entities with two or more owners (i.e., most entities, other than corporations, estates, and trusts) are treated as partnerships for federal tax purposes. Reg. §§ 301.7701-1 through -4, and -7, This would include a general partnership, a limited partnership, limited liability partnership, or limited liability limited partnership.

be uncertain as whether the general partners would admit that buyer as a partner or whether the buyer would be restricted to being an assignee. Assignees may, under applicable state law, have no management rights, withdrawal rights, dissolution rights, or rights to review the books. Third, the limited partners may have taxable income in any given year without a corresponding cash distribution from the partnership. [29]

To provide the best non-tax justification for the FLP, practitioners typically will structure it to have a mix of both investment assets and operating businesses. For example, suppose that Dad transfers growth stocks worth $3.75 million and an operating business worth $1 million solely in exchange for limited partnership interests in a FLP that represents 95 percent of the equity in that entity. Another individual transfers in other, non-income producing assets worth $250,000 solely in exchange for a 5 percent general partnership interest in the entity. Suppose, further, that the stocks generate no, or a *de minimis* amount of, taxable dividends, but that the operating business has the potential for generating taxable income or loss.

If the operating business does generate a loss for the current tax year, the resulting loss would be allocated 95 percent to Dad and 5 percent to the general partner. From the standpoint of the general partner, it should not be difficult to establish material participation in the FLP's activities under one of the seven tests of the IRC Section 469 temporary regulations. As such, the general partner's share of the losses should flow through to and be deductible against ordinary income on his or her income tax return for the current year. However, a different result applies to Dad.

As a limited partner, Dad in all likelihood will be unable to meet one of the three tests necessary to establish material participation. Ignoring Tests 5 and 6 (which focus on participation in past years), Dad would have to participate in the activities of the FLP for more than 500 hours in the current year to be materially participating. However, such level of participation by Dad would be contrary to the goals of not having any control or management functions related to the limited partnership interest. Thus, because of the structure of the FLP necessary to accomplish the desired estate tax savings, Dad's interest in the entity will be a passive activity to him. As a result, the FLP's otherwise ordinary businesses losses would be treated as PALs and, thereby, lost in the short-term and, potentially, forever.

How might this happen? The danger is that the FLP may be held until death.[30] At death, the basis in a limited partnership interest is adjusted[31] for income tax purposes to fair market value (FMV) under IRC Section 1014(a), often referred to as "step-up" or "step-down" basis. That FMV may be a discounted number, but nevertheless the PALs that have accumulated may not be deductible. A transfer of a taxpayer's interest in a passive activity by virtue of the taxpayer's death results in suspended PALs being allowed (generally on the final return of the deceased taxpayer) but only to the extent they exceed the amount, if any, of the step-up in basis allowed.[32]

For example, suppose a taxpayer dies with a passive activity in which they have an adjusted basis of $400,000, suspended PALs of $250,000, and a "discounted" fair market value (FMV) at the

[29] The description of the structural composition of the FLP is liberally taken from the author's previous writings on this subject. See, e.g., Harrison & Janiga, *supra* note 4, at 120-122.
[30] Even if not held until death, to the extent that the PALs are suspended and first deductible in the future, the present value of the tax savings associated with the PAL reduces each year that the deduction is carried forward to the future.
[31] The estate tax laws in 2010 are bizarre and are, accordingly, best viewed as a one year aberration. Accordingly, this article assumes that pre-2010 law applies.
[32] Code Sec. 469(g)(2).

decedent's date of death of $750,000. The step-up in basis would be $350,000 ($750,000 date-of-death FMV - $400,000 adjusted basis). Because the $250,000 of suspended PALs does not exceed the step-up basis amount, $350,000, none of the PALs are deductible by the decedent (or, for that matter, any beneficiary). The suspended PALs "evaporate," thus producing no income tax savings.

Given that a limited partner in a FLP may never get any benefit from his or her PALs, the obvious question arises: Can a membership interest in a FLLC be structured in such a way that it qualifies for estate tax discounts, while at the same time permit the member to be a materially participant for purposes of the PAL rules? Although the answer is not clear, we believe that, depending on state law, the answer may be "yes."

In a FLLC setting, typically any member can participate in the management of the LLC, in forcing a dissolution, or in electing a manager whose ability it is to determine distributions.[33] All of these rights could effect, or even eliminate, the availability of an estate tax discount. Therefore, for an FLLC to work for discounting purposes, the members should have no unilateral right to control the manager, should not be able to become a manager (except a "limited manager" as discussed below), and the state law governing the LLC should provide for a perpetual LLC absent an agreement by the members to the contrary.

While removing control from the LLC members via a manager who is perpetual or self appointing may help to ensure that estate tax discounts are respected, the question is whether such removal will prevent the members from establishing material participation for purposes of the PAL rules. To reach an answer, it is helpful to revisit Dad from our earlier discussion but in the context of a FLLC.

Suppose the same facts except that, instead of receiving a limited partnership interest in a FLP, Dad receives a membership interest that represents 95% of the equity in a FLLC. Will the losses flowing from the FLLC be currently deductible on Dad's income tax return? The answer may depend on how the management of Dad's FLLC is structured.

If structured in the way it is typically done for discount purposes, Dad would have little, if any, involvement with the management of the FLLC. As such, despite *Garnett* and *Thompson* providing that Dad's membership interest should be treated as a general partnership interest, his level of participation would not be sufficient to meet any one of the seven material participation tests applicable to such interests. Thus, he may face the same potential loss of deductibility of the PALs flowing from the operating business as he would as a limited partner in a FLP.

However, if the management of the FLLC is structured in such a way that Dad can meet the lowest threshold test (i.e., Test 3) for material participation, Dad may be able to accomplish both of his objectives – preserving estate tax discount while avoiding the PAL rules. State law

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[33] This assumes that the LLC is member-managed. Generally, there are two types of LLCs: member-managed and manager-managed. While LLC statutes vary state-to-state, most states have adopted in whole or part either the 1996 Uniform Limited Liability Company Act (ULLCA) or the 2006 Revised Uniform Limited Liability Company Act (RULLCA). Using RULLCA as a point of reference, Section 407(b) provides that in a member-managed LLC each member has equal rights in the management of the LLC's business. Section 474(c) provides that in a manager-managed LLC each manager has equal rights in the management of the LLC and that except as expressly provided by the LLC statute, any matter relating to the LLC's activities is decided exclusively by the managers. However, pursuant to Section 110, this "default" rule is subject to the LLC's operating agreement. Further, Section 111(a)(2) states that the operating agreement governs "the rights and duties under this [act] of a person in the capacity of manager."

permitting, in an LLC, a member may still be able to participate as a manager, while not having full control of liquidation and distribution decisions. In other words, it would be possible to structure the LLC so that there are two managers, a decision manager, whose purpose it is to determine if there are distributions, sales, mergers, dissolution and liquidations; and an administrative manager, whose purpose it would be to determine and manage the underlying assets. The administrative manager should be able to hold on to the LLC interests without jeopardizing the estate tax discounts inherent in those interests.

So long as Dad's participates in the activities of the FLLC as administrative manager for more than 100 hours during the year, and his participation in the FLLC is not less than the participation of any other individual, including the decision manager, he will meet Test 1 and, thus, be a material participant. Thus, using the more lenient PAL tests for general partners, the losses from the FLLC flowing from the operating business should avoid the PAL rules, thereby providing current deductibility of such losses against Dad's ordinary income.

Whether this strategy is viable will be contingent on the state law governing the LLC. So long as the state's LLC statute does not expressly prohibit this split in management responsibilities, it should be possible to draft the LLC's operating agreement to effectuate such split.

A FLLC formed under Illinois law, for example, should be able to avail itself of this strategy. Under the Illinois LLC Act ("Act"), while a manager-managed LLC provides that "each manager has equal rights in the management and conduct of the [LLC's] business"[34] and that, except as otherwise provided, "any matter may be exclusively decided by the manager[s],"[35] it also provides that, except as otherwise provided, the "operating agreement may modify any provision or provisions of this Act governing relations among the members, managers, and [LLC]."[36] Because the Act does not limit prevent the operating agreement from modifying the rights to management,[37] it would appear that the agreement could modify such rights consistent with the strategy.

CONCLUSION

Practitioners need to consider various non-tax and tax issues in selecting between a FLP and a FLLC for discount planning purposes. One income tax issue that may be important if the entity is comprised of an operating business that may generate losses is whether such losses will be deductible under the PAL rules. A limited partner in a FLP is unlikely to establish material participation in the activities of the entity under the restrictive tests applicable to limited partners; consequently, the losses of the operating business held by the FLP may not be deductible currently or, perhaps, ever. However, based on *Garnett* and *Thompson*, a membership interest in a FLLC is subject to the more expansive tests applicable to general partners. Though utilizing state LLC law that does not restrict the ability to split management rights and careful drafting of the LLC's operating agreement to reflect such split, it may be possible to structure the FLLC in such a way that a member's interest is subject to estate tax discounts, while avoiding application of the PAL rules.

[34] 805 ILCS 180/15-1(b)(1).
[35] 805 ILCS 180/15-1(b)(2).
[36] 805 ILCS 180/15-5(a).
[37] See 805 ILCS 180/15-5(b)(1)-(7) which lists rights that cannot be limited and elements or restrictions that cannot be contained in the operating agreement.