

## **Tax Court Expands Active Investors Use of LLP and LLC Losses**

A recent decision of the United States Tax Court enables taxpayers who are investors in limited liability partnerships (LLP) and limited liability companies (LLC) to deduct losses against their salaries and investment income. Garnett v. Internal Revenue Service, 132 T.C. No. 19 (2009).

This is a victory for investors who actively participate in the LLP and the LLC because it overturned the Internal Revenue Service's (IRS) long-standing position that such losses were only deductible against the LLP's or LLC's gains. In Garnett, the taxpayers were investors in several agribusinesses in Nebraska that they actively worked in, thus they are considered "active investors." On their tax returns, the Garnetts used the losses from the various agribusinesses to offset "earned income" that they received from other sources. The IRS considered the losses of the businesses to be "passive" for the active investors, and passive losses can only offset passive gains. In other words, the IRS argued the Garnetts' passive losses could not be used to offset the Garnetts' other income such as salaries, capital gains, or dividends. Therefore, according to the IRS, the active investor must carry these "passive" losses forward until the agribusinesses generate a "passive" gain against which the losses may be deducted. The Garnetts challenged this position. The Tax Court sided with the Garnetts, saying that because these investors are active in the business, the passive income rules do not apply here. The Tax Court held that the passive loss rules were not meant to apply to investors such as the Garnetts, who are actively involved in the businesses. Thus the Garnetts were allowed to deduct the losses from the agribusinesses from their other income, thereby reducing their taxable income.

This decision may be very beneficial to many people who invest in LLPs and LLCs and work a few hours for that business while also earning a salary in another full-time job. For example, you invest in a gift shop (which is an LLC) and work in the store for five hours each week. At the same time, you have a full time job at which you earn a salary of \$50,000 a year. At the end of the year, your portion of the loss for the gift shop is \$5,000. Under Garnett, your taxable income is reduced to \$45,000 because the \$5,000 loss can offset part of your earned income.

Tax Court decisions do apply across the nation; however it is important to note that the IRS may appeal this decision to the United States Court of Appeals for the Eighth Circuit. The IRS has yet to comment on the opinion, so it is unclear what course it will take in terms of changing its policy or challenging the Tax Court's ruling. Some tax professionals believe the IRS will appeal this decision and continue to challenge these loss deductions, thus requiring taxpayers to fight this issue in Court. But for now, active investors have reason to hope that they may be able to more fully use their LLP and LLC losses against their other income. For more information on this topic or any other tax-related topic, please do not hesitate to contact me to schedule a free initial consultation at 717-657-7770.

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