



Agricultural Law Press

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Agricultural Law Digest

Volume 16, No. 7

April 8, 2005

ISSN 1051-2780

LLCs and Passive Activity Losses

-by Neil E. Harl*

The hybrid nature of limited liability companies (and limited liability partnerships)¹ has contributed to uncertainty as to how the passive activity loss rules² are to be applied to LLCs and LLPs as well as other hybrid-type organizational structures. Limited liability companies, in particular, have become a highly popular choice for organizing farm and ranch businesses and for holding real estate leased to farm and ranch businesses. A 2005 Tax Court case³ has cast some light on how the passive activity loss rules are to be applied to such hybrid entities.

Overview of passive activity loss rules

In general, deductions from passive trade or business activities, to the extent deductions exceed income from all passive activities (exclusive of portfolio income), may not be deducted against other income.⁴ An activity is considered a passive activity if it involves the conduct of a trade or business and the taxpayer does not materially participate in the activity.⁵ A taxpayer, for this purpose, is treated as materially participating in an activity only if the person "is involved in the operations of the activity on a basis which is regular, continuous and substantial."⁶

The passive loss rules do not refer to limited liability companies or limited liability partnerships but do refer to limited partners in a limited partnership.⁷ Under those rules, losses attributable to limited partnership interests are treated as arising from a passive activity⁸ unless a limited partner participates for more than 500 hours,⁹ materially participated in five or more of the ten preceding years¹⁰ or the activity is a personal service activity in which the limited partner materially participated for any three preceding tax years.¹¹ In general, a partnership interest (and, for tax purposes, an LLC or LLP is considered a partnership) is treated as a limited partnership interest if so designated in the organizational documents or *the liability of the holder of the interest is limited to a fixed, determinable amount under state law* such as the amount contributed to the entity.¹² However, a general partner who holds a limited partnership interest is not necessarily treated as a limited partner.¹³

The 2005 Tax Court Case

In the 2005 Tax Court case, *Al Assaf v. Commissioner*,¹⁴ a husband and wife owned a limited liability company which in turn owned an office building with space rented to law firms. The LLC also provided extensive legal support services to the tenants – handling client intake, answering telephones, taking messages, filing documents, process serving, mailing, binding briefs, conducting legal research, typing briefs and legal memoranda, taking dictation managing a file room and photocopying as well as other housekeeping-type services.¹⁵ One of the 50 percent owners of the LLC, the wife, who was also an

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attorney, managed the legal support service enterprise. The LLC also provided consulting services to attorneys and health maintenance organizations (the other 50 percent owner of the LLC, the husband, was a medical doctor who worked full-time in a medical school).

The LLC incurred losses during the years at issue from the real estate leasing and support services activities which were used to offset gains from the consulting activity with the net losses passed through to the LLC owners.¹⁶ The taxpayers classified the losses as nonpassive which allowed the netting of the losses. The Internal Revenue Service took the position that the LLCs leasing activities were *per se* passive and, therefore, were limited by the passive activity rules.¹⁷

The Tax Court, agreeing with the taxpayers, rejected the IRS argument that the leasing activities were *per se* passive and held that the taxpayers qualified for the “extraordinary personal services” exception under the passive activity rules for rental property.¹⁸ The court agreed that the taxpayers had proved that the use of the leased real property by the tenants was incidental to the receipt of the LLCs services.¹⁹ The temporary regulations state that extraordinary personal services are provided in connection with making property available to users “. . . only if the services provided in connection with the use of the property are performed by individuals, and the use. . . of the property is incidental to their receipt of such services.”²⁰

In addition to proving that the extraordinary personal services exception applied, the taxpayers also had to show that they had materially participated in the activity.²¹ The Tax Court found the testimony compelling that wife’s involvement exceeded the 500 hours required in the first of the seven tests for material participation.²²

In conclusion

The Tax Court concluded that the LLCs activities were not passive activities, the losses were not passive and the losses could be netted with the other income of the LLC. Unless reversed on appeal, this case could be a useful template for planning in other settings where leasing occurs and extraordinary personal services are performed. The rejection of the IRS argument that the leasing activities were *per se* passive was a major development in the case.

FOOTNOTES

¹ See generally 8 Harl, Agricultural Law § 61.02[5](2005); Harl, *Agricultural Law Manual* § 7.04[2][c](2005).

² I.R.C. § 469.

³ Al Assaf v. Comm’r, T.C. Memo. 2005-14.

⁴ I.R.C. § 469. See, e.g., Hillman v. Comm’r, 114 T.C. 103 (2000), *rev’d*, 250 F.3d 228 (4th Cir. 2001), *on remand*, 118 T.C. 323 (2002) (owner of S corporation providing management services to real estate partnership could not offset passive deductions from partnership against nonpassive income from management fees earned by S corporation; real estate activity could not be segregated into separate rental and trade or business activities).

⁵ I.R.C. § 469(c)(1).

⁶ I.R.C. § 469(h)(1).

⁷ Temp. Treas. Reg. § 1.469-5T(e).

⁸ Temp. Treas. Reg. § 1.469-5T(e)(2).

⁹ Temp. Treas. Reg. § 1.469-5T(a)(1).

¹⁰ Temp. Treas. Reg. § 1.469-5T(a)(5).

¹¹ Temp. Treas. Reg. § 1.469-5T(a)(6).

¹² Temp. Treas. Reg. § 1.469-5T(e)(3).

¹³ Temp. Treas. Reg. § 1.469-5T(e)(3)(ii).

¹⁴ T.C. Memo. 2005-14.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ Temp. Treas. Reg. § 1.469-1T(3)(ii)(c).

¹⁹ Al Assaf v. Comm’r, T.C. Memo. 2005-14.

²⁰ Temp. Treas. Reg. § 1.469-1T(e)(3)(v).

²¹ Al Assaf v. Comm’r, T.C. Memo. 2005-14.

²² Temp. Treas. Reg. § 1.469-5T(a)(1).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ANIMALS

BULL. The plaintiff worked as a carpenter for another carpenter who was performing woodworking services for the farmer defendant. The plaintiff was injured by a bull while working in a barn in which the bull was allowed to roam so as to impregnate cows. The plaintiff sued in strict liability and negligence to recover for the injuries. The court held that the defendant would be liable

for personal injuries caused by the bull only if the defendant knew or should have known that the bull had vicious or violent propensities. The plaintiff did not provide any evidence of vicious or violent propensities of the bull and the defendant provided evidence that the bull had never attacked anyone before. The plaintiff provided expert testimony that breeding bulls were generally dangerous and vicious. The court held that evidence of the propensities of bulls in general was insufficient to meet the evidentiary requirement to show the propensities of the bull