



FCG Valuation Case E-Flash

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Issue 11:3

CITATION: Paul D. Garnett and Alicia Garnett v. Commissioner, 132 T.C. No. 19, Docket No. 9898-06, June 30, 2009

COMMENTS:

The IRS asserted that interests in LLCs, LLPs, and tenancies-in-common were limited partnership interests, thereby disallowing losses generated by passive investments. However, the Tax Court determined that the ownership interests were not limited partners and not subject to IRC § 469(h)(2).

THE FACTS:

Paul and Alicia Garnett (the “Garnetts” or “Petitioners”) were general partners in seven limited liability partnerships and non-managing members of two limited liability companies, all of which were engaged in some form of farming or ranching. They also owned interests in two other businesses which they claimed were tenancies-in-common. Although the Petitioners’ tax return only listed Mr. Garnett as a partner or member, neither the Court nor the IRS challenged the Petitioners’ contention that the interests were owned jointly.

Petitioners primarily owned interests in the LLPs indirectly through holding company LLCs and directly owned only one LLP interest. Each Form 1065 Schedule K-1 listed the relevant interest holder as “limited partner”. The LLP agreements generally reduced the partners’ liability for partnership debts and stated that each partner would actively participate in the management and direction of the partnerships’ business activities.

The Garnetts also owned interests in two LLCs, one directly and one through a holding company. Each Schedule K-1 listed the relevant interest holder as a “limited liability company member”. The business of the two LLCs was to be conducted exclusively by a managing member, selected by majority vote of the LLC’s members. The Petitioners were not managers in either of the LLCs in which they owned interests.

Finally, the Garnetts indirectly owned interests (through a holding company) in two other businesses (“tenancies-in-common”) which operated as de facto partnerships and owned rental real estate.

During 2000, 2001, and 2002, the Petitioners claimed losses attributable to the various business entities mentioned above.

DISCUSSION:

IRC § 469 defines and sets forth the terms for the tax treatment of passive entities. In particular, § 469(b) generally defines a passive entity as one in which the taxpayer does not materially participate. § 469 (c)(1) defines material participation as regular, continuous, and substantial involvement in the business operations. § 469 (h)(1) lists seven exclusive tests for determining material participation. § 469(h)(2) states:

Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which the taxpayer materially participates.

The IRS argued that the Petitioners' interests in the various companies should be considered as limited partners in limited partnerships, which then presupposes that the subject interests' income is generated from passive activities. Underlying the IRS position was inability of the subject interests to control the parent entities, and the limited liability the interests received in exchange for the lack of control.

[Note: The holding companies were disregarded by the IRS in this matter and the Garnetts did not dispute the IRS' position.]

The Petitioners argued that § 469(h)(2) was not applicable because none of the companies in which they owned interests were limited partnerships and because the subject interests were general partner interests rather than limited partner interests.

The Court disagreed with the IRS position and cited the legislative history of the regulations in finding that although Congress considered limited liability in its passing of § 469(h)(2), limited liability was neither the only nor the determinative factor.

Further, Congress believed that statutory restriction on a limited partner's ability to manage the business meant the limited partner did not materially participate. The Tax Court believed such logic did not apply to the subject interests, as the subject interests were not restricted statutorily from participation in company management.

Accordingly, the Tax Court ruled subject interests were all general partners within the meaning of the regulations.

CONCLUSION:

Although the characteristics of the subject interests differed in many respects from general partnerships' general partners, their status differed more from limited partnerships' limited partners. As a result, the subject interests were not subject to § 469(h)(2) and losses generated by the interests were allowed by the Tax Court.

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