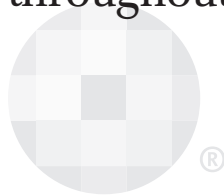


LLC Members and the Passive Activity Loss Rules: IRS Issues Proposed Regulations After Multiple Court Setbacks

By Hale E. Sheppard

Hale E. Sheppard discusses the changing environment of passive activity rules and the issuance of new proposed regulations within the context of Code Sec. 469. The author reviews case law throughout the past decade and the evolution of a new definition of “limited” for passive activity purposes.



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Introduction

Change is inevitable, particularly in the tax arena. The world evolves at such a quick pace that the Treasury and the IRS frequently find themselves playing catch up. Examples of this abound, but a recent event of interest involves the IRS’s attempt to deprive certain taxpayers of losses because of their decision to conduct business through limited liability companies (LLCs).

Congress, focused on combating “tax shelters” in the 1980s, passed Code Sec. 469(h)(2). This provision creates a legal presumption that a taxpayer who owns an interest in a limited partnership, as a limited partner, cannot utilize any losses flowing from the entity to offset the taxpayer’s unrelated, active income from other endeavors. For its part, the Treas-

ury promulgated regulations over two decades ago containing special tests, rules and exceptions for limited partnerships. The problem, as one might expect, is that time marched on, and the states introduced different types of business entities, such as LLCs. Taxpayers began participating in activities through LLCs, some of which generated losses. The IRS, citing the limited partnership regulations from yesteryear, started challenging the LLC-related losses on grounds that they were “passive.” Tax disputes ensued over the next decade, and the taxpayers were triumphant in each instance. In light of these repeated judicial defeats, the Treasury recently acknowledged that the existing regulations under Code Sec. 469(h)(2) were outdated and thus issued new proposed regulations in late November 2011.

This article examines the congressional motives for attacking limited partnerships, the existing regulations that triggered the controversy, the five taxpayer victories in various courts, the IRS’s recent decision to surrender the fight and the proposed regulations, which radically alter the definition of “limited” for passive activity purposes.

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Overview of Code Sec. 469

To appreciate the impact of the recent proposed regulations under Code Sec. 469(h)(2), one must first understand the pertinent rules.

A Look at Material Participation

Generally, a taxpayer may only deduct the losses from “passive” trade or business activities in a particular year to the extent that such losses do not exceed income from “passive” activities.¹ Thus, a taxpayer ordinarily cannot use passive losses to offset income from unrelated, nonpassive activities and cannot claim passive losses inasmuch as they surpass passive income during a given year. The disallowed losses, which are also known as “suspended losses,” ordinarily can be taken when the taxpayer disposes of his or her entire interest in the passive activity in question.²

Taxpayers often structure their business affairs in a manner that allows them to avoid the negative impact of the passive activity loss limitation rules of Code Sec. 469. This includes ensuring that the taxpayer is “materially participating” in the relevant activity or activities. The term “passive activity” is defined in the negative. It generally means any activity involving the conduct of a trade or business in which the taxpayer does not “materially participate.”³ To meet the “material participation” standard, the taxpayer must demonstrate that he or she is involved in the operations of the activity on a regular, continuous and substantial basis.⁴ The regulations contain additional guidance on this topic, stating that the taxpayer normally is treated as “materially participating” in an activity if he or she meets any one of the following seven tests.⁵

- **Test 1.** The taxpayer participates in the activity for more than 500 hours during the year.
- **Test 2.** The taxpayer’s participation in the activity during the year constitutes substantially all of the participation in such activity by all individuals for such year.
- **Test 3.** The taxpayer participates in the activity for more than 100 hours during the relevant year, and his or her participation is not less than that of any other individual for such year.
- **Test 4.** The activity is a “significant participation activity” during the year, and the taxpayer’s aggregate participation in all significant participation activities during such year exceeds 500 hours.
- **Test 5.** The taxpayer materially participated in the activity for any five tax years (consecutive or

not) during the 10 years immediately preceding the year at issue.

- **Test 6.** The activity is a “personal service activity,” and the taxpayer materially participated in such activity for any three years (consecutive or not) before the year at issue.
- **Test 7.** Based on all of the facts and circumstances, taking into account the special rules found elsewhere in the regulation, the taxpayer participates in the activity on a regular, continuous and substantial basis during such year.

Material Participation and Limited Partnerships

There are various exceptions to the preceding general rules, of course. One applies to participation in an activity through a limited partnership. The relevant statute, Code Sec. 469(h)(2), states the following:

Except as provided in the regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.⁶

In other words, Code Sec. 469(h)(2) establishes a harsh legal presumption: taxpayers owning an interest in a limited partnership, as a limited partner, ordinarily will not be deemed to be materially participating in the trade or business activities of the limited partnership. The loss-limitation rules of Code Sec. 469, therefore, would apply.

The application of this legal presumption is expanded in the regulations, which contain three pieces of critical guidance.⁷

First, the regulations serve to lessen the harshness of the legal presumption in Code Sec. 469(h)(2) by allowing the taxpayer some latitude to demonstrate that he or she materially participated in the activities of the limited partnership. In particular, the regulations provide that a limited partner will overcome the legal presumption of passivity if he or she can satisfy one of the following three material participation tests: Test 1, Test 5 or Test 6.⁸ Using deductive reasoning, the regulations indicate that broaching any of the remaining material participation tests (*i.e.*, Test 2, Test 3, Test 4 or Test 7) would constitute an act of futility for limited partners.

Second, the regulations define when a partnership interest will be treated as a “limited partnership interest.” Reg. §1.469-5T(e)(3)(i) generally states that a partnership interest shall be treated as a “limited partnership interest” if either one of the following is true:

Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law [“The-Documents-Speak-for-Themselves Theory”], *or*

The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder’s capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership) [“State-Law-Limited-Liability Theory”].

Finally, the regulations establish that a *general* partner is not a *limited* partner subject to the legal presumption of passivity. In this regard, Reg. §1.469-5T(e)(3)(ii) states the following:

A partnership interest of an individual shall *not* be treated as a limited partnership interest for the individual’s tax year if the individual is a *general partner* in the partnership at all times during the partnership’s tax year ending with or within the individual’s tax year (or the portion of the partnership’s tax year during which the individual (directly or indirectly) owns such limited partnership interest) [“General Partner Exception”].

In light of these repeated judicial defeats, the Treasury recently acknowledged that the existing regulations under Code Sec. 469(h)(2) were outdated and thus issued new proposed regulations in late November 2011.

It stated in reports that extensive tax shelter activity created the perception that only the naïve and the unsophisticated actually paid their fair share.⁹

To combat this problem, Congress decided to implement some changes, including the enactment of Code Sec. 469 in 1986.¹⁰ This legislation placed considerable emphasis on the concept of “material participation,” which Congress believed would help stem the tax shelter epidemic. The rationale for the material participation rules was fairly straightforward. Congress posited that a taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant, nontax, economic profit motive.¹¹ Congress also pointed out that a passive investor is primarily seeking a return on the capital invested, rather than an ongoing source of livelihood.¹² Consequently, reasoned Congress, introducing the material participation standard would reduce the importance of the tax-reduction

aspects of a particular investment, while simultaneously increasing the significance of the true economic features.¹³

In its efforts to lessen tax considerations in making investments, Congress turned its focus to the limited partnership, which it labeled the vehicle of choice for tax sheltering at

that time.¹⁴ Congress left little ambiguity in its reasons for creating the special rules for limited partnership interests in Code Sec. 469(h)(2) and for authorizing the Treasury to promulgate regulations in this area. The following portions of congressional reports reveal congressional intent.

[S]ince a limited partner generally is precluded from participating in the partnership’s business if he is to retain his limited liability status, the committee believes it should not be necessary to examine general facts and circumstances regarding material participation in this context. Therefore, under the bill, a limited partnership interest is treated as intrinsically passive (except as provided in the regulations).¹⁵

In general, under the relevant State laws, a limited partnership interest is characterized by limited liability, and in order to maintain limited liability

A Review of Legislative History—Targeting Limited Partnerships

Without some context, neither Code Sec. 469 nor the special rules dealing with limited partnerships make much sense. It is worthwhile, therefore, to take a glimpse into the collective mind of Congress in passing the relevant rules. The IRS felt besieged by what it considered “tax shelters” in the early 1980s. Congress, for its part, was concerned that such transactions were taking an inordinate toll on the federal tax system.

status, a limited partner, as such, cannot be active in the partnership's business.¹⁶

Because a limited partner generally is precluded from materially participating in the partnership's activities, losses and credits attributable to the limited partnership's activities are generally treated as from passive activities¹⁷

Recurrent Losses for the IRS in Limited Liability Company Cases

The number of reported court decisions and IRS rulings addressing Code Sec. 469(h)(2) and the relevant regulations was remarkably small, at least until lately.¹⁸ The IRS suffered its first loss in 2000, with four defeats coming in rapid succession in 2009 and 2010. These five important cases, which serve as the impetus for the recent issuance of proposed regulations, are examined below.

***S.A. Gregg*—IRS Loss Number One (in District Court)**

The taxpayer in *S.A. Gregg* was the CEO for a managed health care company, where he worked on a full-time basis until selling his stock in the company in November 1994.¹⁹ That same month, taxpayer formed Cadaja LLC, a limited liability company organized under the laws of Oregon. He intended to transfer the business techniques he had developed in traditional medicine, at his former company, to the field of alternative medicine, at Cadaja. The taxpayer hired two people away from his former company, each of whom became members of Cadaja, worked 40 hours per week in 1994 and received a salary. For his part, the taxpayer worked a total of 100 hours at Cadaja during that initial year, but did not draw a salary. Taking a salary made no sense to the taxpayer since he, as sole financier of Cadaja, would simply be contributing and receiving the same funds.

Cadaja filed a Form 1065 for 1994 with the IRS showing a flow-through loss to the taxpayer of approximately \$230,000, which is not atypical for a start-up business. The taxpayer reported this amount as an ordinary loss on his Form 1040 for 1994. The IRS audited the taxpayer, at the conclusion of which it issued a Notice of Deficiency recharacterizing the loss from Cadaja as a passive loss, asserting a corresponding tax deficiency and imposing an accuracy-related penalty. The taxpayer

paid the requisite amounts and filed claims for refund. Once the IRS rejected these claims, the taxpayer filed suit in the U.S. District Court for Oregon.

The court recognized the importance of this case in November 2000, identifying it as one involving an "issue of first impression."²⁰ That issue, as summarized by the court, was "whether [the taxpayer], a member of an LLC, should be treated as a limited partner or a general partner in a limited partnership for Section 469 purposes."²¹

At trial, the taxpayer first raised the General Partner Exception, as found in Reg. §1.469-5T(e)(3)(ii). He contended that Cadaja was formed under Oregon law, which distinguishes between limited partners and general partners not on the basis of liability, but rather on the extent of control a partner has over the business. Since none of the members of Cadaja were restricted under Oregon law, Cadaja's articles of organization or Cadaja's operating agreement, *all* members, including the taxpayer, should be treated as general partners.²² The government, on the other hand, relied on the State-Law-Limited-Liability Theory, derived from Reg. §1.469-5T(e)(3)(i)(B). It suggested that the laws of the state in which Cadaja was organized (*i.e.*, Oregon) extend limited liability to all members; therefore, the taxpayer's interest in Cadaja should be treated as a limited partnership interest.²³ The taxpayer countered by stating that the State-Law-Limited-Liability Theory, as raised by the government, was "obsolete" when it comes to LLCs and their members because state LLC statutes, such as Oregon's, create a "a new type of business entity that is materially distinguishable from a limited partnership."²⁴

The court agreed with the taxpayer, basing its decision on the following foundation. First, the court explained the differences between LLCs and limited partnerships, including the fact that a limited partnership must have at least one general partner who is personally liable for the obligations of the entity, whereas all members of an LLC may have limited liability. The court further explained that members of an LLC retain limited liability irrespective of their level of participation in the management of the entity, while a limited partner is precluded, by definition, from participating in entity management.²⁵ Indeed, stated the court, "LLCs are designed to permit active involvement by LLC members in the management of the business."²⁶ Second, the court turned to legislative history to decipher what, exactly, Congress intended upon enacting Code Sec. 469. The court determined that Congress, in passing the special rules related

to limited partnerships, was principally concerned about preventing investors from deducting passive losses from tax-shelter investments against unrelated, nonpassive income.²⁷ The court did not believe that the taxpayer in *S.A. Gregg* was engaged in the type of activity that Congress aimed to thwart. Finally, and perhaps most importantly, the court indicated that those in charge of promulgating regulations, and not the taxpayer, were to blame. In this regard, the court made this holding: “In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, defendant’s conclusion [that the State-Law-Limited-Liability Theory applies] is inappropriate.”²⁸

Based on the preceding reasoning, the court ruled that the higher standard of material participation (under which the taxpayer must satisfy Test 1, Test 5 or Test 6) did not apply.²⁹ The taxpayer could satisfy any one of the seven material participation tests, which the court found he did. Accordingly, the court held that the passthrough loss from Cadaja in 1994 was non-passive, and not subject to the passive loss restrictions on deductibility.³⁰

***P.D. Garnett* – IRS Loss Number Two (in Tax Court)**

Approximately eight-and-one-half years after the district court issued its decision in *S.A. Gregg*, the Tax Court addressed a similar case in June 2009. In *P.D. Garnett*, the taxpayers held interests in seven LLPs, two LLCs and two other business ventures characterized as tenancies-in-common.³¹ All of these entities, formed under Iowa law, engaged in agricultural activities, such as the production of poultry, eggs and hogs.

On their Forms 1040 for the relevant years, the taxpayers reported the income and losses from their interests in the entities. Predictably, the IRS disallowed the losses and subjected them to the passive activity loss limitation rules of Code Sec. 469 based on the argument that the taxpayers failed to “materially participate” in the activities. The taxpayers filed a timely petition with the Tax Court, after which both the taxpayers and the IRS filed motions for summary judgment on the issue of whether the taxpayers’ ownership interests in the entities were

subject to the special rules for limited partnerships in Code Sec. 469(h)(2).

The taxpayers advanced two main theories. First, relying on *S.A. Gregg*, they argued that the special rules under Code Sec. 469(h)(2) are inapplicable, as they only pertain to “limited partnerships.” The taxpayers did not have an interest in a limited partnership; rather, they owned interests in LLPs, LLCs and tenancies-in-common. Second, even if the special rules were relevant, the taxpayers would fall under the General Partner Exception in Reg. §1.469-5T(e)(3)(ii).

The IRS took contrary positions on these two points. With respect to the first theory, the Tax Court seemed to administer equal justice by not resolving the issue in favor of either party. The IRS acknowledged that there are differences among limited partnerships, LLPs and LLCs, but claimed that such distinctions are irrelevant because the “sole relevant consideration”

To meet the “material participation” standard, the taxpayer must demonstrate that he or she is involved in the operations of the activity on a regular, continuous and substantial basis.

is that the taxpayers had limited liability. The Tax Court explained that such an abbreviated analysis overlooks the fact that the operative condition for applying Code Sec. 469(h)(2) in the first place is not simply that a taxpayer has “an interest in a limited partnership,” but rather that it

be an “interest in a limited partnership as a limited partner.”³² The taxpayers tried to persuade the court that Code Sec. 469, and the regulations thereunder, should be read literally, adhering to the principle of strict constructionism. Since neither addresses LLPs, LLCs or tenancies-in-common, the taxpayers contended that they, quite simply, do not apply. The Tax Court discredited this argument too, citing legislative history that speaks to regulatory authority to treat “substantially equivalent entities” as limited partnerships for purposes of Code Sec. 469(h)(2).

The Tax Court indicated that the second argument, concerning whether the General Partner Exception applies, would be decisive. The court pointed out that the term “general partner” is not generally defined in the Code or regulations. In the absence of a definition in these primary sources, the IRS argued that “general partner” should mean one who has actual or apparent authority to act for and bind the partnership. The IRS did not dispute that Iowa law did not preclude the taxpayers from actively participating in the management and activities of the LLPs, LLCs and

tenancies-in-common. It also did not deny that the taxpayers played at least some role in the management of the entities. However, the IRS contended that these points are insufficient to classify the taxpayers as “general partners.” The IRS suggested that the court, in determining the applicability of Code Sec. 469(h)(2), make an initial factual inquiry about the type and extent of the taxpayers’ authority to act on behalf of the entities. The court rejected this notion, explaining that doing so would essentially allow the exception to swallow the rule: “To import them into the per se rule of Section 469(h)(2) would tend, we believe, to blur the special rule and the general rules for material participation in a manner that is at odds with the statutory framework and legislative intent.”

The court then cited two portions of the legislative history, which were featured earlier in this article, explaining the congressional reasons behind introducing the legal presumption of passivity in cases of limited partnerships. Rooted in this history, the court reasoned that while limited liability of the partners was one characteristic of limited partners that Congress considered in enacting Code Sec. 469(h)(2), it was not, as the IRS suggested, the “sole or even determinative consideration.” Rather, the court said, the salient consideration was the limited ability of the partners to participate in the partnership’s business. Unlike limited partners in limited partnerships, those holding interests in LLPs and LLCs are not prohibited by state law from participating in the entities’ business. Therefore, the court reasoned, no presumption that the taxpayers did not materially participate can exist.

The court then concluded that, after giving appropriate deference to the legislative purpose of Code Sec. 469(h)(2), the taxpayers were shielded from the passive activity loss rules by the General Partner Exception; that is, they held their ownership interest in the entities as “general partners.” Similar to the District Court in *S.A. Gregg*, the Tax Court appeared critical of the “absence of explicit regulatory provisions” and the “need to pigeonhole the ownership interests as either general partner interests or limited partner interests [arising] in the first instance from the fiction of treating an LLP or an LLC as a limited partnership” under the temporary regulations.³³

***J.R. Thompson*—IRS Loss Number Three (in Court of Federal Claims)**

On the heels of *P.D. Garnett* came the decision in *J.R. Thompson* in July 2009.³⁴ Like the others, this case constituted “a question of first impression for the court.”

The taxpayer in *J.R. Thompson* formed an LLC under Texas law. He owned directly a 99-percent interest in the LLC; he also owned the remaining one percent indirectly through an S corporation. In addition to his ownership interests, the taxpayer was designated the managing member. The taxpayer claimed large ordinary losses on his Forms 1040 flowing from the LLC during the years at issue. The IRS conducted an audit, disallowed essentially all of the losses on the grounds that the taxpayer did not materially participate in the activity and assessed the resulting tax deficiency. In response, the taxpayer paid the requisite amount, filed a claim for refund and, after such claim was rejected by the IRS, filed a refund suit in the Court of Federal Claims. The parties then filed cross-motions for partial summary judgment on the issue of whether a member interest in an LLC (for state law purposes) that is treated as a partnership (for federal tax purposes) constitutes a “limited partnership interest” in the context of Section 469.

The arguments in these types of cases are, at this point, clear-cut. The government primarily advanced the State-Law-Limited-Liability Theory pursuant to Reg. §1.469-5T(e)(3)(i)(B) because, under Texas law, the taxpayer’s liability for the LLC was limited. For his part, the taxpayer raised the same two defenses advanced by the taxpayers in *P.D. Garnett*. The special rules for limited partnerships in Code Sec. 469(h)(2) only affect “limited partnerships,” and the taxpayer is a member in an LLC. Moreover, even if the special rules were applicable, the taxpayer would be protected by the General Partner Exception in Reg. §1.469-5T(e)(3)(ii), because of the high degree of control he exerted over the business operations of the LLC.

Like the District Court in *S.A. Gregg* and the Tax Court in *P.D. Garnett*, the Court of Federal Claims rendered a taxpayer-favorable decision in *J.R. Thompson*. However, the bases for these outcomes varied.

The court initially delved into statutory construction, noting that the relevant canons apply with equal force to statutory provisions and regulations. The court looked to the text of the General Partner Exception, which provides that a partnership interest shall be considered a limited partnership interest if the liability of the taxpayer holding the interest “is limited *under the law of the State in which the partnership is organized.*”³⁵ According to the court, the italicized portion literally requires that the interest be in an entity that, in fact, is a “partnership” under the applicable state law, not merely taxed as a partnership for federal tax purposes. Lest any doubt remain, the court stated that

“[t]his provision is unambiguous [therefore] the court must enforce its plain meaning.”³⁶

Still adhering to strict statutory interpretation, the court next turned its attention to the provision on which the relevant regulations are predicated, Code Sec. 469(h)(2). That provision states, in pertinent part, that “no interest in a limited partnership *as a limited partner*” shall be treated as an interest with respect to which a taxpayer materially participates.³⁷ Therefore, reasoned the court, the taxpayer must actually be a limited partner for the provision to even apply. The court points out that, here, the LLC was organized under Texas law as an LLC, not as a limited partnership, and the taxpayer is a member of such LLC, not a limited partner.

The court then highlighted the fact that the government ignored the possibility that the taxpayer met the General Partner Exception. The court deemed this “remarkable” considering that the regulation on which the government primarily relies begins as follows: “Except as provided in paragraph (e)(3) (ii) of this section,” which is precisely where the General Partner Exception is found. The court confirmed that the government twice conceded during oral argument that the taxpayer would be a general partner if the LLC were a limited partnership. Nevertheless, the government asked the court to equate the taxpayer’s interest in the LLC to that of a limited partnership interest for purposes helpful to the government (*i.e.*, for applying the State-Law-Limited-Liability Theory), while at the same time requesting that the court deny the taxpayer the benefit of the General Partner Exception. The court labeled this dichotomy “entirely self-serving and inconsistent.”³⁸

Next, the court addressed the government’s contention that the taxpayer should be considered a limited partner because at the time Code Sec. 469 was enacted, in 1986, and when the Treasury regulations were promulgated, in 1988, there was “universal agreement” among the states that the defining factor of a limited partnership interest was “limited liability.” The court pointed out that the limited partnership was not a novel business entity in 1986. Indeed, the first Uniform Limited Partnership Act (ULPA) was drafted

in 1916 and the Revised ULPA (RULPA) followed in 1976. By the time Congress passed Code Sec. 469, almost all states, including Texas, had adopted one of the two. Based on its review of these two acts, the court held that “when Congress enacted [Code Sec. 469] there was general agreement among state laws that a limited partner would lose his limited liability status if he participated in the control of the business. Stated another way, a limited partner’s *level of participation in the business* dictated whether or not he enjoyed limited liability.”³⁹ The court turned to the surrounding statutory and regulatory framework to strengthen this conclusion. It stated that the pivotal terms, “material participation” and “passive activity,” indicate, on their face, that the government was principally concerned with a taxpayer’s degree of involvement in a given activity. The court closes on this rhetorical question: “If Congress had desired a test that turned on a taxpayer’s level of liability, it surely

would have included the word ‘liability’ somewhere in the statute.”⁴⁰

A rejection of the government’s argument based on legislative history was next on the court’s agenda. The court began by clarifying that there is no need to resort to legislative history in this situation because, as explained above, the pertinent statutory provision

and regulations are unambiguous. However, even if the court were required to review legislative history, it would favor the taxpayer, not the government. The court explained that the “only piece of legislative history” that aids the government is a Senate report, which purportedly authorizes the Treasury Department to issue regulations to treat “substantially equivalent entities” as limited partnerships for purposes of Code Sec. 469(h)(2). The court cited the following portion of the report:

[T]he Secretary of the Treasury is empowered to provide through regulations that limited partnership interests in certain circumstances will *not* be treated (other than through the application of the general facts and circumstances test regarding material participation) as interests in passive activities.

* * *

The IRS acknowledged that there are differences among limited partnerships, LLPs and LLCs, but claimed that such distinctions are irrelevant because the “sole relevant consideration” is that the taxpayers had limited liability.

The exercise of *such authority* might also be appropriate where taxpayers sought to avoid limited partnership status with respect to substantially equivalent entities.

The court said the preceding language is unclear and potentially nonsensical, as the phrase “such authority” could be taken to mean that Congress granted the IRS authority to treat a taxpayer’s interest in an entity as nonpassive (and thus not subject to the passive loss limitations) where a taxpayer employed a “substantially equivalent entity” to avoid the restrictions on limited partnerships. The court also underscored the fact that an LLC is not “substantially equivalent” to a limited partnership interest. For example, unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability. The court summarized its thoughts on this issue as follows: “Once Treasury Regulation §1.469-5T(e) (3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC.”⁴¹

Finally, referring to *P.D. Garnett*, the court held that even if Reg. §1.469-5T(e)(3) could apply to the taxpayer, thereby forcing the court to classify his member interest in LLC as either a limited partner interest or general partner interest, it would fall under the protection of the General Partner Exception. In the words of the court, at best, the government has identified an ambiguity in the regulations as they apply to LLCs, and “the court should decide such ambiguities in favor of the taxpayer.”⁴²

***S.K. Hegarty*—IRS Loss Number Four (in Tax Court)**

The taxpayers in *S.K. Hegarty* had regular, full-time jobs in the Washington, D.C. area: he was employed by a mortgage company, and she worked as a real estate salesperson.⁴³ Presumably, the taxpayers decided at some point that they had endured enough of the daily grind, thank you very much, and decided to start a business of their own in a more agreeable climate. In August 2003, the taxpayers formed a Maryland LLC called “Blue Marlin,” through which they con-

ducted a charter fishing business. As with most small businesses, Blue Marlin hit some rough waters (pun intended) during its first year. Specifically, its 2003 Form 1065 showed income of \$9,583 and expenses of \$74,161, rendering a net loss of \$64,578. This loss flowed from Blue Marlin to the taxpayers, who reported it on Schedule E to their 2003 Form 1040.

The taxpayers maintained a time log in which they noted the time spent on each activity related to Blue Marlin, but the log was lost during the taxpayers’ move from the Mid-Atlantic region to Florida. The taxpayers, using receipts and other materials, reconstructed the time log. It demonstrated that the taxpayers had participated in Blue Marlin’s business for more than 100 hours in 2003 and that they were essentially the only individuals who participated. In other words, the reconstructed log indicated that the taxpayers met Test 3 of the material participation standards.

The IRS, relying on Code Sec. 469(h)(2) and the underlying regulations, took the same position that they took (and lost) in *S.A. Gregg, P.D. Garnett* and *J.R. Thompson*. In particular, the IRS argued that “because the business was conducted through a limited liability company, [the taxpayers] are treated as limited partners in con-

sidering whether they materially participated in the business.” While the taxpayers may have satisfied Test 3, contended the IRS, this is insufficient because the taxpayers, as limited partners, must meet Test 1, Test 5 or Test 6.

Citing *P.D. Garnett*, the Tax Court observed that the IRS’s reliance on Code Sec. 469(h)(2) in this situation was misplaced. It then held that the taxpayers were allowed to satisfy the material participation standard by meeting *any* of the seven Tests, and the taxpayers had fulfilled Test 3.

***L.E. Newell*—IRS Loss Number Five (in Tax Court)**

The taxpayer in *L.E. Newell* was a wise man, a lawyer who decided not to practice law.⁴⁴ Instead of measuring his life by the billable hour, he devoted his time to two primary endeavors. First, he actively engaged in the business of a California S

The general rule, under both the existing and proposed regulations, remains that an individual is not treated as materially participating in any activity in which such individual owns a limited partnership interest as a limited partner.

corporation, Millworks, Inc. (“Millworks”), which manufactured and installed cabinets, doors, trim and other carpentry items. Millworks generated significant losses during the years at issue. Second, he owned a 33-percent interest in Pasadera Country Club (“Pasadera”), a California LLC treated as a partnership for federal income tax purposes. In addition to owning one-third of Pasadera, the taxpayer also served as the managing member. He had numerous duties and responsibilities in this capacity, including hiring and firing personnel, overseeing construction of a clubhouse, creating and administering membership programs, reviewing and approving membership applications, reviewing and issuing checks to cover construction and operational expenses, making the annual filings for liquor licenses, handling various legal issues, and negotiating all construction and permanent loans for Pasadera. The taxpayer was also personally liable for Pasadera’s loans. Like Millworks, Pasadera lost a sizable amount of money during the relevant years, which generated losses that passed to the taxpayer in proportion to his ownership interest.

The IRS initiated an audit of the taxpayer’s Forms 1040 for 2001, 2002 and 2003. It concluded that the losses from both entities were passive under Code Sec. 469, such that they were suspended. This conclusion by the IRS ultimately found its way into a notice of deficiency, which the taxpayer timely challenged in Tax Court.

The parties agreed before trial that the taxpayer met Test 4 of the material participation standards; that is, they recognized that the taxpayer’s participation in Millworks and Pasadera constituted a “significant participation activity” in which the taxpayer spent more than 500 hours in the aggregate. This agreement notwithstanding, the IRS argued that the taxpayer cannot deduct the losses stemming from Pasadera because it is an LLC and, pursuant to Code Sec. 469(h)(2), the taxpayer was a “limited partner” who must satisfy Test 1, Test 5 or Test 6 (not Test 4).

The Tax Court framed the issue by describing Code Sec. 469(h)(2), the underlying regulations, and the analysis in *P.D. Garnett*. It then turned to the taxpayer’s interest in Pasadera. The Tax Court explained that, under California law, a member of an LLC can participate in management and, under Pasadera’s operating agreement, the taxpayer, as managing member, had the right to participate in management. By contrast, observed the Tax Court, a limited partner

in a California limited partnership stands to lose his limited liability if he gets involved in management. Next, the Tax Court rejected the IRS’s contention that Code Sec. 469(h)(2) applied to the taxpayer because it “fails to recognize that in order for Section 469(h)(2) to apply at all, [the taxpayer] must have held an ownership interest in a limited partnership as a limited partner [and the taxpayer] did not.” The Tax Court went on to explain that, if it were to generally analogize an LLC in California to a limited partnership, then the members would more closely resemble general partners than limited partners. Narrowing this analogy, the Tax Court held that the taxpayer in *L.E. Newell* functioned as the “substantial equivalent of a general partner” in Pasadera because he managed the day-to-day operations and assumed other responsibilities. The Tax Court concluded that the General Partner Exception applied, such that the taxpayer’s interest in Pasadera would not be treated as a limited partnership interest. The ultimate resolution of the case flowed easily from there. Code Sec. 469(h)(2) did not apply because of the General Partner Exception; therefore, the taxpayer could meet the material participation standard by satisfying any of the seven Tests. The IRS stipulated before trial that the taxpayer met Test 4 because his combined involvement in “significant participation activities” (*i.e.*, Millworks and Pasadera) exceeded 500 hours. Since the taxpayer met Test 4, he was allowed to deduct the losses in 2001, 2002 and 2003 originating in those two entities.

The IRS Finally Changes Its Tune

After suffering five major defeats on the same issue, the IRS caused the Treasury to change its tune through the issuance of proposed regulations. This action was seemingly taken with a degree of reluctance, though.

Audit Technique Guide on Passive Activities

An IRS attorney from the National Office explained at a tax event in 2010 that the IRS still felt comfortable with its litigation stance concerning Code Sec. 469(h)(2), even after the initial setback in *S.A. Gregg*.⁴⁵ This ongoing confidence in its legal position was evident from the fact that the IRS continued to advance tax disputes on Code Sec. 469(h)(2) issues years later in *P.D. Garnett*, *J.R. Thompson*, *S.K. Hegarty* and *L.E. Newell*. This confidence was also clear from the in-

ternal messages that the IRS was sending to its foot soldiers, the tax examiners.

The District Court rendered its decision in *S.A. Gregg* in 2000. As explained above, the court made several significant holdings in that case of first impression. For instance, it ruled that the State-Law-Limited-Liability Theory, originating in Reg. §1.469-5T(e)(3)(i), was “obsolete” when it comes to LLCs and their members because state LLC statutes create “a new type of business entity that is materially distinguishable from a limited partnership.”⁴⁶ The court in *S.A. Gregg* also made this critical holding: “In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, defendant’s conclusion [that the State-Law-Limited-Liability Theory applies] is inappropriate.”⁴⁷ Accordingly, the court found that the taxpayer in *S.A. Gregg*, a member of an LLC, could avoid the passive activity loss limitation rules by satisfying any one of the seven material participation tests.⁴⁸

The IRS did not issue an action on decision indicating whether, or to what extent, it would follow the decision the *S.A. Gregg*. Instead, the IRS simply ignored the court precedent and forged ahead. Confirmation of this is found in the *Passive Activity Loss Audit Technique Guide*, released in February 2005 (“2005-ATG”), more than four years after *S.A. Gregg*.⁴⁹ The 2005-ATG acknowledges the existence of *S.A. Gregg* and describes one of its holdings as “LLC member not a limited partner.”⁵⁰ So far, so good. Then, however, the IRS effectively discards this important case of first impression, classifying it as “not a precedent setting case.”⁵¹ Following this mindset, the 2005-ATG contains statements echoing those from the earlier version: “Since each member of an LLC has limited liability, investors are analogous to limited partners under IRC §469. For purposes of passive loss rules, LLC members are treated as limited partners, even if the taxpayer is a member-manager.”⁵² The 2005-ATG also features an entire section entitled “Material Participation by LLCs.” This segment imparts the following syllogism to tax examiners: “a partnership interest will be treated as a limited partnership interest if the liability of the holder is limited under the law of the State. Under most state laws, an LLC member has limited liability. Therefore, LLC members are treated as limited partners.”⁵³ The ensuing page contains an even broader statement about how revenue agents and tax compliance officers should make audit decisions: “Members of LLCs are treated as limited partners for purposes of the passive loss rules.”⁵⁴

The 2005-ATG essentially obligated the revenue agents, tax compliance officers and others at the front line to adhere to the 2005-ATG, even if they were aware of *S.A. Gregg* and the possibility that any proposed adjustments at the audit level that were inconsistent with *S.A. Gregg* might be defeated at trial. This is because the role of tax examiners is severely restricted. According to the Internal Revenue Manual, examiners possess the authority to reach conclusions regarding tax issues after a “balanced and impartial evaluation of all the evidence,” but they lack the power to consider any “hazards of litigation” for the IRS in making their findings.⁵⁵ In other words, tax examiners, in making decisions at the front end (*i.e.*, during an audit) are largely precluded from taking into account how the dispute is likely to conclude on the back end (*i.e.*, after litigation).

Action on Decision by IRS in 2010

The IRS advanced unfazed for many years after its first loss in *S.A. Gregg* in 2000, but it engaged in some reflection after repeatedly losing the Code Sec. 469(h) (2) issues in other courts. One IRS attorney explained it in the following manner:

After the IRS’s initial judicial loss in district court [*i.e.*, *Gregg v. United States*], the government still felt comfortable with its position and continued to rely on the [existing regulations about limited partners] ... After losing four cases in the past six months, however, the IRS has had to take a step back and acknowledge that its rules aren’t working very well.⁵⁶

The IRS’s acknowledgement came in the form of an Action on Decision, in result only, in *J.R. Thompson*.⁵⁷ The IRS “acquiesced in result only,” which means that the IRS accepted the holding of the court and will follow it in disposing of cases with the same controlling facts, yet disagrees with some or all of the reasoning by the court in reaching its conclusions.⁵⁸ This Action on Decision was released in 2010, 10 years after *S.A. Gregg*, and on the tail of the taxpayer-favorable rulings in *P.D. Garnett*, *J.R. Thompson*, *S.K. Hegarty* and *L.E. Newell*.

Proposed Regulations in 2011

The Treasury released its proposed regulations regarding Code Sec. 469(h)(2) in late November 2011, approximately one-and-one-half years after the IRS issued its Action on Decision in *Thompson*.⁵⁹ The

preamble to this proposed guidance acknowledges that the present regulations are outdated:

Recognizing that the original presumptions regarding the limitations on a limited partner's participation in the activities of the entity are no longer valid today, and also recognizing the emergence of LLCs, the proposed regulations eliminate the current regulations' reliance on limited liability for purposes of determining whether an interest is an interest in a limited partnership as a limited partner under section 469(h)(2) and instead adopt an approach that relies on the individual partner's right to participate in the management of the entity.⁶⁰

The general rule, under both the existing and proposed regulations, remains that an individual is *not* treated as materially participating in any activity in which such individual owns a limited partnership interest as a limited partner.⁶¹ Other than minor changes to conform the exception to the updated general rule, the proposed regulations retain the requirement that an individual can only overcome the general nonmaterial-participation presumption if he meets Test 1, Test 5 or Test 6.⁶² In other words, the IRS did not expand the exception to allow individuals to meet *any* of the seven material participation tests. The proposed regulations also did little to change the existing General Partner Exception, such that individuals will still not be treated as holding a limited partnership interest as a limited partner as long as they also hold a state-law general partnership interest at all relevant times.⁶³

The most notable changes in the proposed regulations focus on Reg. §1.469-5(e)(3)(i). Understanding what modifications the IRS suggests is complicated by the manner in which proposed regulations are publicly issued. It is helpful, therefore, to rearrange the presentation style and compare the existing rules with the proposed rules. This comparison is set forth below.⁶⁴

Existing Regulation

[Except as provided in the General Partner Exception], for purposes of section 469(h)(2) and

this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law [*i.e.*, The-Documents-Speak-for-Themselves Theory]; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership) [*i.e.*, State-Law-Limited-Liability Theory].

Proposed Regulation

Given the frequent use by taxpayers of LLCs and other hybrid entities, the IRS's propensity to challenge losses based on the passive activity rules and the ... proposed regulations, the debate is far from over.

[Except as provided in the General Partner Exception], for purposes of section 469(h)(2) and this paragraph (e), an interest in an entity shall be treated as an interest in a limited partnership as a limited partner if—

(A) The entity in which such interest is held is classified as a partnership for Federal income tax purposes under §301.7701-3; and

(B) The holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement.

The preceding indicates that, in determining if an individual holds a limited partnership interest as a limited partner (and thus will *not* be treated as materially participating in the activity), the IRS proposes to focus first on whether the entity in question is classified as a "partnership" for federal income tax purposes under the entity-classification rules

found at Reg. §301.7701-3. A business entity that is not otherwise considered a “corporation” under the applicable standards can elect its own classification for federal tax purposes.⁶⁵ Eligible entities with two or more members can choose to be classified as a corporation or a partnership, while those with a single owner can be a corporation or a so-called disregarded entity.⁶⁶ This choice is memorialized by filing a Form 8832, Entity Classification Election with the IRS.⁶⁷ If a domestic eligible entity with two or more members fails to make an affirmative election, the default rule generally dictates that it is treated as a “partnership.”⁶⁸ Apparently, by directing the analysis to the entity-classification rules under Reg. §301-7701-3, the Treasury wants to jettison the The-Documents-Speak-for-Themselves Theory, thereby disregarding how the ownership interest is described in the entity agreements, certificates, etc.

Provided that the entity in question is properly classified as a “partnership” for federal income tax purposes under Reg. §301.7701-3, the Treasury next intends to look at whether the individual had the “right to manage the entity” (not whether he actually engaged in management activities) under state law and the entity agreement. In effect, the IRS wants to abandon the

State-Law-Limited-Liability Theory, which centers on whether a taxpayer’s liability for partnership obligations is “limited,” and replace it with a State-Law-and-Entity-Agreement-Management-Rights Theory, which prioritizes whether a taxpayer’s ability to control or manage the partnership is “limited.” If, pursuant to the partnership/operating agreement and state law, the individual lacked the right to manage the entity, then his or her interest would be considered “limited” under the proposed regulations, regardless of the extent to which the individual is liable for obligations of the entity.

Conclusion

The string of losses by the IRS in *S.A. Gregg, P.D. Garnett, J.R. Thompson, S.K. Hegarty* and *L.E. Newell* sparked a significant amount of commentary from the tax community.⁶⁹ Given the frequent use by taxpayers of LLCs and other hybrid entities, the IRS’s propensity to challenge losses based on the passive activity rules and the new standards introduced by the Treasury in the proposed regulations, the debate is far from over. Taxpayers and their advisors would be wise to follow this issue, both before and after the regulations under Code Sec. 469(h)(2) are finalized.⁷⁰

ENDNOTES

- 1 Code Sec. 469(a)(1)(A) and (d)(1).
- 2 Code Sec. 469(g).
- 3 Code Sec. 469(c)(1).
- 4 Code Sec. 469(h)(1).
- 5 Temporary Reg. §1.469-5T(a).
- 6 See also Temporary Reg. §1.469-5T(e)(1).
- 7 T.D. 8175, 1988-1 CB 191. The temporary regulations were issued in 1988; they have never been adopted in final form.
- 8 Temporary Reg. §1.469-5T(e)(2).
- 9 S. REP. NO. 313, at 713-714 (1986).
- 10 Act Secs. 501 and 502 of the Tax Reform Act of 1986 (P.L. 99-514).
- 11 S. REP. NO. 313, at 716 (1986).
- 12 *Id.*
- 13 *Id.*
- 14 *Id.* at 720. This report recognized that “[t]he form of the entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership.” *Id.*
- 15 *Id.*
- 16 *Id.* at 731.
- 17 H.R. REP. NO. 841, II-145 (1986) (Conf. Rep.).
- 18 See LTR 8810079 (Dec. 17, 1987); LTR 8827030 (July 8, 1988); *M.D. Lee*, 91 TCM 999, Dec. 56,476(M), TC Memo 2006-70; and *P.N. Lowe*, 95 TCM 1377, Dec. 57,403(M), TC Memo 2008-98.
- 19 *S.A. Gregg*, DC Ore., 2001-1 USTC ¶ 50,169, 186 FSupp2d 1123.
- 20 *Id.* at 1127.
- 21 *Id.*
- 22 *Id.* at 1127-28.
- 23 *Id.* at 1128.
- 24 *Id.*
- 25 *Id.*
- 26 *Id.*
- 27 *Id.*
- 28 *Id.* at 1129.
- 29 *Id.*
- 30 *Id.* at 1133-34. Certain practitioners have praised the results, but not the reasoning, of this case. See Steven G. Frost and Sheldon I. Banoff, *Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs*, 100 J. TAXATION 326, 335-36 (June 2004) (stating the District Court in *S.A. Gregg* “may have reached the correct conclusion as a policy matter, but its logic may be difficult to reconcile with other cases.”)
- 31 *P.D. Garnett*, 132 TC 368, Dec. 57,875 (2009). The taxpayers owned most of these interests indirectly through holding LLCs.
- 32 *Id.* (emphasis supplied by the court).
- 33 *Id.*
- 34 *J.R. Thompson*, FedCl, 2009-2 USTC ¶ 50,501 87 FedCl 728.
- 35 *Id.* (emphasis supplied by the court).
- 36 *Id.*
- 37 *Id.* (emphasis supplied by the court).
- 38 *Id.*
- 39 *Id.* (emphasis added).
- 40 *J.R. Thompson*, FedCl, 2009-2 USTC ¶ 50,501 87 FedCl 728.
- 41 *Id.*
- 42 *Id.*
- 43 *S.K. Hegarty*, T.C. Summ. Op. 2009-153 (Oct. 6, 2009).
- 44 *L.E. Newell*, 99TCM 1107, Dec. 58,127(M), TC Memo 2010-23.
- 45 Jeremiah Coder, *No Decisions Yet on Coming Material Participation Guidance*, IRS Official Says, 2010 TAX NOTES TODAY 47-2 (March 11, 2010).
- 46 *S.A. Gregg*, DC Ore., 2001-1 USTC ¶ 50,169, 186 FSupp2d 1123, 1128.
- 47 *Id.* at 1129.
- 48 *Id.* at 1133-34.
- 49 *IRS Passive Activity Loss Audit Technique Guide* (Training No. 3149-115 (02-2005), Catalog No. 83479V, <http://prod.resource.cch.com/resource/scion/document/default/%28%40%40MSS01+P216002%2909013e2c83a4ee02?cfu=TAA>).
- 50 *Id.* at 1-7, 1-9 (emphasis added).
- 51 *Id.*
- 52 *Id.* at 6-10.
- 53 *Id.* at 6-11.
- 54 *Id.* at 6-12.
- 55 I.R.M. §4.75.14.2.2 (08-16-2006).
- 56 Jeremiah Coder, *No Decision Yet on Coming Material Participation Guidance*, IRS Official Says, 2010 TAX NOTES TODAY 47-2

ENDNOTES

- (March 11, 2010).
- ⁵⁷ Action on Decision 2010-02, 2010-14 IRB 515 (April 5, 2010).
- ⁵⁸ *Id.*
- ⁵⁹ REG 109369-10, Fed. Reg. 2011-30611 (Nov. 28, 2011).
- ⁶⁰ *Id.*
- ⁶¹ Temporary Reg. §1.469-5T(e)(1) and Proposed Reg. §1.469-5(e)(1). The proposed regulation is more precise in that specifies that the general non-material-participation rule applies where individuals “own an interest in a limited partnership as a limited partner.” The existing regulation is broader, listing “any activity of a limited partnership.”
- ⁶² Prop. Reg. §1.469-5(e)(2).
- ⁶³ Prop. Reg. §1.469-5(e)(3)(ii).
- ⁶⁴ The proposed regulations also contain suggested changes to Reg. §1.469-9(f)(1), which address limited partnership interests in rental real estate activities. Such changes are not covered in this article because they are not pivotal to the discussion.
- ⁶⁵ Reg. §301.7701-3(a).
- ⁶⁶ Reg. §301.7701-3(a).
- ⁶⁷ Reg. §301.7701-3(c)(1)(i).
- ⁶⁸ Reg. §301.7701-3(b)(1).
- ⁶⁹ See, e.g., Banoff and Lipton, *Passive Losses, LLCs and LLPs—Two Courts Reject the Service’s Attempt to Limit Losses*, 111(4) J. TAX’N (Oct. 2009); Stevens, *After Garnett, Thompson, and Hegarty: LLC Members’ Losses No Longer Presumed Passive?* 12(2) BUSINESS ENTITIES (March/April 2010); 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, Sept. 2009, at 7.
- ⁷⁰ The deadline for submitting comments and requests for a public hearing regarding the proposed regulations to Code. Sec. 469(h)(2) is not until February 27, 2012. However, practitioners have already started identifying areas of ambiguity in the proposed regulations, and the principal author thereof has acknowledged that clarifications may be necessary. See Amy S. Elliott, *IRS May Clarify Limited Partner Interest Test in Material Participation Regs*, 2012 TAX NOTES TODAY 7-1 (Jan. 11, 2012).

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