Strike Three for the IRS in Passive Activity Loss Cases: Courts United in Rejecting Outdated Limited Partnership Theories

By Hale E. Sheppard

Hale Sheppard examines three cases—*S.A. Gregg, P.D. Garnett* and *J.R. Thompson*—where courts have rejected the IRS's approach to classifying taxpayers owning interests in limited liability entities in the same manner as limited partners in limited partnerships.

Introduction

Even the best ideas ultimately run their course. The key is recognizing when this eventuality has occurred, which proves challenging in many instances. A prime example is found in the passive activity loss rules of Code Sec. 469. This provision, enacted by Congress in 1986, was aimed at thwarting the "tax shelters" that were, by all accounts, rapidly eroding the public's confidence in the federal tax system. Congress considered limited partnerships particularly problematic, as they constituted the entity of choice for those involved in shelters. Therefore, Congress created a legal presumption in Code Sec. 469(h)(2) that a taxpayer owning an interest in a limited partnership, as a limited partner, generally would not be able to use the "passive" losses flowing from the entity to offset the taxpayer's unrelated, active income from another endeavor. The IRS then promulgated temporary regulations in 1988 containing special tests, theories and exceptions applicable to limited partnerships.

Time, of course, did not stand still. States began recognizing various types of unincorporated business entities, such as the limited liability company (LLC), limited liability partnership (LLP), and limited liability limited partnership (LLLP), to name a few. These structures were distinct in many ways, but they shared one feature: limited liability to the investor. Taxpayers started participating indirectly in activities through these new entities, and the IRS often challenged the characterization of the resulting losses. In doing so, the IRS relied on the statute and regulations, passed eons ago, which expressly applied to limited partnerships. It was an awkward fit, a square-peg-meet-round-hole situation, yet the IRS persisted for many years.

This situation may change now as a result of three notable cases, *S.A. Gregg* (in the U.S. District Court),[1] *P.D. Garnett* (in the U.S. Tax Court),[2] and *J.R. Thompson* (in the Court of Federal Claims).[3] These judicial decisions, as well as the relevant material leading to them, are examined in this article.

Hale E. Sheppard (B.S., M.A., J.D., LL.M., LL.M.T.) is a shareholder in the Atlanta office of Chamberlain Hrdlicka, White, Williams & Martin specializing in tax audits, administrative appeals, tax litigation and tax collection defense. You can reach Hale by phone at (404) 658-5441 or by e-mail at hale.sheppard@chamberlainlaw.com

Overview of Code Sec. 469

Definition and Importance of Material Participation

To appreciate the importance of the three major court decisions regarding Code Sec. 469, one must first have an overall understanding of the pertinent rules. 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.[4] 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, can be carried forward and treated as deductions from passive activities in subsequent tax years.[5] Moreover, in many instances, the remaining suspended losses can be taken in full when the taxpayer disposes of his entire interest in the passive activity in question.[6]

The ability to eventually use the passive losses provides a certain degree of solace to taxpayers, but time, as they so often say, is money. Perhaps nowhere is this more accurate than with taxes, where timing can be pivotal. Therefore, 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, as explained below.

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."[7] To meet the "material participation" standard, the taxpayer must demonstrate that he is involved in the operations of the activity on a regular, continuous and substantial basis.[8] The regulations contain additional guidance on this topic, stating that the taxpayer is treated as "materially participating" in an activity if he meets any one of the following seven tests.[9]

- 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 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 exceptions to the preceding general standards and tests, of course, one of which applies to participation in an activity through a limited partnership. The relevant statute, Code Sec. 469(h)(2), states that, "[e]xcept 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."[10] In other words, Code Sec. 469(h)(2) establishes a harsh legal presumption: those 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 temporary regulations, which contain three pieces of critical guidance.[11] First, they 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 materially participated in the activities of the limited partnership. In particular, the regulations provide that a limited partner will overcome the legal presumption if he can satisfy one of the following three material participation tests: Test 1, Test 5, or Test 6.[12] 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." Setting forth the actual regulatory language is necessary, as it becomes pivotal to understanding the three major cases in this area. Reg. §1.469-5T(e)(3)(i) states that, except as provided in the exception found in Reg. §1.469-5T(e)(3)(ii), a partnership interest shall be treated as a "limited partnership interest" if either 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 ("You-Said-It-Yourself 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) ("Limited Liability Theory").

Congress considered limited partnerships particularly problematic, as they constituted the entity of choice for those involved in shelters.

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

> A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest) ("General Partner Exception").

A Review of Legislative History

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. It stated in reports that extensive tax shelter activity created the perception that only the naïve and the unsophisticated actually paid their fair share, this view exacerbated the problem as more people jumped into the tax shelter market, investment capital was thus being diverted from productive activities to those designed primarily to avoid taxes, and the entire federal income tax system was threatened.[13]

To combat this threat, Congress decided to implement some changes, including the enactment of Code Sec. 469 in 1986.[14] 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, non-tax, economic profit motive.[15] Congress also pointed out that a passive investor is primarily seeking a return on the capital invested–including a return in the form of tax reductions on active income unrelated to the passive activity–rather than an ongoing source of livelihood.[16] Consequently, reasoned Congress, introducing the material participation standard would reduce the importance of the tax-reduction aspects of a particular investment, while increasing the significance of the true economic features.[17]

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.[18] 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 IRS 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).[19]

In general, under the relevant State laws, a limited partnership interest is characterized by limited liability, and in order to maintain limited liability status, a limited partner, as such, cannot be active in the partnership's business.[20]

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 activities . . .[21]

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Three Strikes for the IRS in Limited Partnership Cases

The number of IRS rulings and reported court decisions addressing Code Sec. 469(h)(2) and the relevant regulations has been remarkably small, at least until lately.[22] This is somewhat surprising, given the frequency with which taxpayers use limited liability entities and the IRS's penchant for auditing passive activity issues. Although all the rulings and cases contain interesting elements, the three of most legal significance are undoubtedly *Gregg, Garnett* and *Thompson*. These cases are analyzed below.

S.A. Gregg–Strike One to the IRS (in District Court)

The taxpayer in *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. 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 being 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."[23] 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."[24]

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 was 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.[25] The government, on the other hand, relied on the 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.[26] The taxpayer countered by stating that the 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."[27]

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.[28] Indeed, stated the court, "LLCs are designed to permit active involvement by LLC members in the management of the business."[29] 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.[30] The court did not believe that the taxpayer in *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 Limited Liability Theory applies] is inappropriate."[31]

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.[32] The taxpayer could satisfy any one of the seven material participation standards, which the court found he did. Accordingly, the court held that the passthrough loss from Cadaja in 1994 was nonpassive, and not subject to the passive loss restrictions on deductibility.[33]

P.D. Garnett—Strike Two to the IRS (in Tax Court)

Approximately eight and one-half years after the District Court issued its decision in *Gregg*, the Tax Court addressed a similar case in June 2009. In *Garnett*, the taxpayers held interests in seven LLPs, two LLCs and two other business ventures characterized as tenancies-in-common.[34] 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 *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 own 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. §1.469-5T9e)(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" 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*."[35] 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 Internal Revenue 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 passiveness 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 *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.[36]

J.R. Thompson—Strike Three to the IRS (in Court of Federal Claims)

On the heels of *Garnett* came the decision in *Thompson* in July 2009.[37] Like the others, this case constituted "a question of first impression for the court."

The taxpayer in *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 it 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 Code Sec. 469.

The arguments in these types of cases are, at this point, clear-cut. The government primarily advanced the Limited Liability Theory pursuant to Treas. 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 *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 *Gregg* and the Tax Court in *Garnett*, the Court of Federal Claims rendered a taxpayer-favorable decision. 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*."[38] 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."[39]

The IRS did not issue an Action on Decision indicating whether, or to what extent, it would follow the decision the *Gregg*. Instead, the IRS simply ignored the court precedent and forged ahead undaunted.

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.[40] 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 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."[41]

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."[42] 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 statement: "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."[43]

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 that 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.
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> * * *
>
> 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."[44]

Finally, referring to *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 LLC, and "the court should decide such ambiguities in favor of the taxpayer."[45]

How Did It Come to This?

The three strikes delivered in *Gregg*, *Garnett* and *Thompson* have sparked interest in the tax community.[46] They have also drawn attention from the general public.[47] What seems to be lacking from the discussion, though, is the genesis of the issue. This is, perhaps, the most interesting aspect of all.

Let's consider some major items on the timeline. Congress introduced the passive activity loss limitation rules, including the special treatment for limited partnerships under Code Sec. 469(h)(2), in 1986.[48] A little more than a year later, in February 1988, the IRS issued temporary regulations.[49] This temporary guidance, which was never finalized, contained the seven tests for establishing "material participation."[50] It also included the unique rules applicable to limited partnerships, among them the You-Said-It-Yourself Theory, the Limited Liability Theory and the General Partner Exception.[51] In 1993, Congress modified Code Sec. 469 as part of the Omnibus Budget Reconciliation Act ("OBRA").[52] The major change in this legislation was the introduction of Code Sec. 469(c)(7), which provides that rental real estate activities of certain taxpayers are not subject to the general rule treating all rental activities as passive activities. Approximately one and one-half years later, in January 1995, the IRS released proposed regulations to reflect changes made by OBRA to the passive loss rules.[53] This presented the IRS with an opportunity to make changes to the special rules regarding limited partnerships, had it been inclined to do so. The preamble to the proposed regulations left no doubt that the IRS, following Congress's lead, intended no shift from its original position adopted in 1988. It states the following:

> Section 469(c)(7) provides that the new rules for rental real estate activities are not to be construed as affecting the determination of whether a qualifying taxpayer materially participates with respect to any interest in a limited partnership as a limited partner. Thus, material participation with respect to a limited partnership interest is determined in accordance with Section 469(h)(2), which provides that limited partners are treated as material participants only to the extent provided in regulations.[54]

The next year, 1996, the IRS released the so-called Passive Activity Loss Audit Technique Guide ("1996-ATG").[55] In its own words, the 1996-ATG was developed to provide revenue agents and other tax auditors with "specific tools to examine issues relating to both income and losses" and "specific guidance on potential audit issues, suggestions for issue identification, and leadsheets which can be used by the agent or auditor for assistance in examining a given issue."[56] Chapter 5 of the 1996-ATG, dealing with entity issues, takes some liberties in citing Reg. §1.469-5T(e) for the following broad proposition: "Since each member of an LLC has limited liability, investors are analogous to limited partners. Thus, for purposes of the passive loss rules, LLC members should be treated as limited partners even if the taxpayer is a member-manager."[57] Based on this unsupported statement, the 1996-ATG goes on to explain that an LLC member can rid itself of the "limited partner taint," if he can demonstrate that he meets one of the three designated material participation tests, *i.e.*, Test 1, Test 5 or Test 6. The 1996-ATG points out, however, that a taxpayer's chances of meeting one of these tests are slim: "They are rarely seen on audit."[58]

The District Court rendered its decision in *Gregg* in 2000. As explained above, the court made several significant holdings in that case of first impression. For instance, it ruled that the 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."[59] The court 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 Limited Liability Theory applies] is inappropriate."[60] Accordingly, the court found that the taxpayer, a member of an LLC, could avoid the passive activity loss limitation rules by satisfying any one of the seven material participation standards.[61]

The IRS did not issue an Action on Decision indicating whether, or to what extent, it would follow the decision the *Gregg*. Instead, the IRS simply ignored the court precedent and forged ahead undaunted.

The best evidence of the IRS's to-heck-with-the-District-Court approach is found in the revised Passive Activity Loss Audit Technique Guide, released in February 2005 ("2005-ATG"), more than four years after *Gregg*.[62] The 2005-ATG acknowledges the existence of *Gregg* and describes one of its holdings as "LLC member *not* a limited partner."[63] So far, so good. Then, however, the IRS effectively discards this important case of first impression, classifying it as "not a precedent setting case."[64] 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."[65] 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."[66] 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."[67] Moreover, the 2005-ATG states in several places that members of LLCs must meet one of three specific tests (*i.e.*, Test 1, Test 5 or Test 6) to satisfy the material participation standard, as opposed to one of the seven tests normally available to other taxpayers.[68]

In short, economic and business realities changed over time, but the rules created by the government, particularly the temporary regulations demanding special tax treatment for those holding interests in limited partnerships, did not.

The problem with the 2005-ATG is three-fold. First, many of the statements and purported rules concerning the tax treatment of LLC members for purposes of Code Sec. 469 are contrary to the holdings by the District Court in *Gregg*. Second, the IRS presented the 2005-ATG as training material to revenue agents and tax compliance officers, who act as the IRS's foot soldiers, those making first contact with the taxpayers, those tasked with initially determining whether a tax liability exists. Finally, and most significantly, the IRS essentially obligated the foot soldiers to adhere to the 2005-ATG, even if they were aware of *Gregg* and the possibility that any proposed adjustments at the audit level that were inconsistent with *Gregg* could be defeated at trial. Defeated, that is, after the taxpayer has been forced to spend vast quantities of time, money and other resources defending himself during the audit, before the IRS Appeals Office, and, finally, at trial. This situation arises, in part, 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.[69] 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). By contrast, the taxpayer, who must personally foot the bill for fighting the IRS, invariably evaluates his chances of prevailing in the end, and makes decisions accordingly.

Conclusion

When passed in the late 1980s, neither the legal presumption of passiveness for limited partnership interests under Code Sec. 469(h)(2) nor the corresponding regulations were problematic. Indeed, the government had a legitimate goal of curtailing "tax shelters," as well as the preferred entity for sheltering at that time, the limited partnership. The trouble began later as states continued introducing new types of business entities featuring limited liability, including the LLC, LLP, and LLLP. In short, economic and business realities changed over time, but the rules created by the government, particularly the temporary regulations demanding special tax treatment for those holding interests in limited partnerships, did not. The situation deteriorated further when the IRS gave no credence to the taxpayer-favorable ruling from the first major case to address the issue, *Gregg*. The training materials supplied to revenue agents and tax compliance offers as recently as 2005 leave no doubt as to the marching orders the IRS was providing its foot soldiers. The consequence was predictable: Numerous tax disputes over the years with taxpayers relying on *Gregg*, on one side, and the IRS relying on its own interpretation of its own regulations issued many moons ago, on the other.

The recent decisions in *Garnett* and *Thompson*, combined with the previous decision in *Gregg*, should trigger change in this area of the law, finally. The form of such change is yet to be determined. Will the IRS issue an Action on Decision explaining its future litigation position? Will Congress modify Code Sec. 469(h)(2)? Will the IRS retract or modify Reg. §1.469-5T(e)? Will the IRS update its training manual for tax examiners, the 2005-ATG, to reflect the recent judicial precedent? And, on a more pressing note, how will the IRS handle the limited partnership cases that are already scheduled for conference with the IRS Appeals Office or set for trial? The applicability of the passive activity loss rules is broad; therefore, tax practitioners, and many taxpayers, will be eagerly awaiting answers to these and other questions.

Endnotes

1 *S.A. Gregg,* DC Ore., 2001-1 USTC ¶ 50,169, 186 FSupp2d 1123.
2 *P.D. Garnett,* 132 TC No. 19, Dec. 57,875 (June 30, 2009).
3 *J.R. Thompson,* FedCl, 2009-2 USTC ¶ 50,501 (July 20, 2009).
4 Code Sec. 469(a)(1)(A); Code Sec. 469(d)(1).
5 Code Sec. 469(b).
6 Code Sec. 469(g).
7 Code Sec. 469(c)(1).
8 Code Sec. 469(h)(1).
9 Reg. §1.469-5T(a).
10 *See also* Reg. §1.469-5T(e)(1).
11 T.D. 8175, 1988-1 CB 191, 53 FR 5686 (Feb. 25, 1988). The temporary regulations were issued in 1988; they have never been adopted in final form.
12 Reg. §1.469-5T(e)(2).
13 S. Rep. No. 99-313, at 713-714 (1986).
14 Tax Reform Act of 1986 (P.L. 99-514), Act Secs. 501 and 502.
15 S. Rep. No. 99-313, at 716 (1986).
16 *Id.*
17 *Id.*
18 *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.*
19 *Id.*
20 *Id.* at 731.
21 H.R Conf. Rep. No. 99-841, at II-145 (1986).
22 *See* LTR 8810079 (Dec. 17, 1987); LTR 8827030 (Apr. 8, 1988); *M.D. Lee,* 91 TCM 999, Dec. 56,476(M), TC Memo. 2006-70; and *P.N. Rogers,* 95 TCM 1377, Dec. 57,403(M), TC Memo 2008-98.
23 *S.A. Gregg,* DC Ore., 2001-1 USTC ¶ 50,169, 186 FSupp2d 1123, 1127.
24 *Id.*
25 *Id.* at 1127-1128.
26 *Id.* at 1128.
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.*
31 *Id.* at 1129.
32 *Id.*
33 *Id.* at 1133-1134. Certain practitioners have praised the results, but not the reasoning, of this case. *See* Steven G. Frost & Sheldon I. Banoff, *Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs,* 100 J.Tax'n 326, 335-336 (June 2004) (stating the District Court in *Gregg* "may have reached the correct conclusion as a policy matter, but its logic may be difficult to reconcile with other cases.")
34 *P.D. Garnett,* 132 TC No. 19, Dec. 57,875 (June 30, 2009).The taxpayers owned most of these interests indirectly through holding LLCs.
35 *Id.* (emphasis supplied by the court).
36 *Id.*
37 *J.R. Thompson,* FedCl, 2009-2 USTC ¶ 50,501 (July 20, 2009).
38 *Id.* (emphasis supplied by the court).
39 *Id.*
40 *Id.* (emphasis supplied by the court).

Endnotes

41 *Id.*

42 *Id.* (emphasis added); *See also* Steven G. Frost & Sheldon I. Banoff, *Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs,* 100 J.Tax'n 326, 335 (June 2004) (explaining that "Congress created the material participation and active participation presumptions for LP interests because Congress believed the holders of such interests could not participate under state law without losing the cloak of limited liability. This belief was generally no longer valid in 1986 (when Congress enacted Section 469), particularly with respect to LPs organized in a state that had adopted RULPA.")

43 *J.R. Thompson,* FedCl, 2009-2 ustc ¶50,501 (July 20, 2009).

44 *Id.*

45 *Id.*

46 *See, e.g.*, Jeremiah Coder and Amy S. Elliott, Another Court Rejects Passive Loss Limits on LLC Interests, 2009 TNT 138-1 (July 22, 2009), 124 Tax Notes 311 (July 27, 2009).

47 *See, e.g.*, Richard Piersol, *Beatrice Tax Case Possible Landmark; Court Says Couple's Losses from LLCs, LLPs Can Be Used to Reduce Taxes on Other Income*, Lincoln J. Star, at p. A10 (July 19, 2009); Laura Saunders, *Entreprenuers Win Tax Case Versus IRS*, Wall St. J., at C1 (July 8, 2009).

48 Tax Reform Act of 1986 (P.L. 99-514), Act Secs. 501 and 502. The rules generally applied to tax years beginning after December 31, 1986.

49 T.D. 8175, 1988-1 CB 191, 53 FR 5686 (Feb. 25, 1988)..

50 Reg. §1.469-5T(a).

51 Reg. §1.469-5T(e)(3).

52 Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) ("OBRA")

53 PS-80-93, T.D. 8645, 1996-1 CB 73, 60 FR 2557 (Dec. 21, 1995).

54 *Id.* at 2558. For similar statements by Congress, *see* H.R. Rep. No. 103-111, at 612 (1993).

55 IRS Passive Activity Loss Audit Technique Guide (1996 WL 315580).

56 *Id.* at Introduction.

57 *Id.* at Chapter 5—Entity Issues.

58 *Id.* at Exhibit 3-1—Interview Questions.

59 *S.A. Gregg*, DC Ore., 2001-1 ustc ¶50,169, 186 FSupp2d 1123, 1128.

60 *Id.* at 1129.

61 *Id.* at 1133-1134.

62 IRS Passive Activity Loss Audit Technique Guide (Training No. 3149-115 (02-2005), Catalog No. 83479V.

63 *Id.* at 1-7, 1-9 (emphasis added).

64 *Id.*

65 *Id.* at 6-10.

66 *Id.* at 6-11.

67 *Id.* at 6-12.

68 *Id.* at 6-11, 6-20.

69 I.R.M. §4.75.14.2.2 (08-16-2006).