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ANALYZING THE IRS'S INCONSISTENT POSITIONS ON THE MEANING OF "LIMITED PARTNER"

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This article, which is the third in a series about the IRS's "Compliance Campaign" focused on SECA taxes and pass-through entities, compares and contrasts the positions taken by the IRS on the concept of who qualifies as a "limited partner" in two important areas – first, under the passive activity loss and material participation rules, and, second, in self-employment tax cases.

Introduction

Business has evolved more quickly than tax law in many ways, and this has led the Internal Revenue Service ("IRS") to take conflicting positions about the meaning of "limited partner." The IRS is characterizing this term broadly or narrowly, in different contexts, in furtherance of its goal of maximizing tax revenue.

When it comes to the passive activity loss-limitation rules in Section 469, the IRS argues that "limited partner" must be loosely defined. This is because the rules generally provide that a "limited partner" does *not* "materially participate" in the relevant activity. Therefore, *including* as many taxpayers as possible in the "limited partner" category benefits the IRS for purposes of Section 469.

By contrast, when a case involves whether certain amounts from partnerships should be subject to self-employment taxes, also known as Self Employment Contributions Act ("SECA") taxes, the IRS argues that a tight definition of "limited partner" is appropriate. This is because Section 1402 indicates that the distributive share of income items to a "limited partner" is *not* hit with SECA taxes. In other words, *excluding* the greatest number of taxpayers from the "limited partner" group helps the IRS when dealing with Section 1402.

This article, which is the third in a series about the IRS's "Compliance Campaign" focused on SECA taxes and pass-through entities, compares and contrasts the positions taken by the IRS in two important areas.[1]

The IRS's Position in Passive Activity Loss Cases – Broad Interpretation

It is in the IRS's financial best interest to interpret the concept of "limited partner" broadly, to encompass the maximum number of taxpayers when addressing Section 469 issues. Why? Because there is a legal presumption that "limited partners" are not "materially participating" in the relevant activities, so they receive passive losses from the partnerships, and their ability to utilize such losses from a tax perspective is restricted.

Overview of Section 469. One must first understand the pertinent rules about passive activity

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losses to appreciate the special rules for "limited partners."

Standards and Tests for Material Participation.

A taxpayer generally may only deduct losses from "passive" trade or business activities in a particular year to the extent that such losses do not exceed income from "passive" activities.[2] Consequently, a taxpayer ordinarily cannot use passive losses to offset income from unrelated, non-passive activities, and cannot claim passive losses if they surpass passive income. The taxpayer cannot claim the disallowed losses, also known as "suspended losses," until he disposes of his entire interest in the passive activity in question.[3]

Taxpayers often arrange their business affairs to avoid the negative impact of the passive activity loss-limitation rules of Section 469. This includes ensuring that they are "materially participating" in the relevant activity.

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."[4] To meet the "material participation" standard, the taxpayer must demonstrate that he meets any one of the following seven tests.[5]

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- *Test 1.* The taxpayer participates in the activity more than 500 hours during the year.
- *Test 2.* The taxpayer's participation in the activity constitutes substantially all the participation in such activity by all individuals during the year.
- *Test 3.* The taxpayer participates in the activity more than 100 hours during the year, and his participation is not less than that of any other individual.
- *Test 4.* The activity is a "significant participation activity," and the taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours.
- *Test 5.* The taxpayer materially participated in the activity for any five tax years (consecutive or not) during the ten years immediately preceding the year at issue.
- *Test 6.* The activity is a "personal service activity," and the taxpayer materially participated in it for any three years (consecutive or not) before the year at issue.
- *Test 7.* Based on all the facts and circumstances, taking into account the special rules found elsewhere in the regulations, the taxpayer participated in the activity on a regular, continuous, and substantial basis during such year.

Special Rules for Limited Partners.

There are various exceptions to the general rules described above. One applies to participation in an activity through a limited partnership. The relevant statute, Section 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.*

At first glance, Section 469(h)(2) appears to establish a harsh legal presumption: The IRS and the courts will start with the idea that a taxpayer owning an interest in a limited partnership, as a limited partner, is not materially participating in the activities of such partnership. The loss-limitation rules of Section 469, therefore, would apply to the detriment of the taxpayer. However, the regulations supply four clarifications about the legal presumption applicable to limited partners.[6]

First, the regulations allow the taxpayer some latitude to demonstrate that he materially participates in the activities of the limited partnership. In particular, a limited partner will overcome the legal presumption of passivity if he can satisfy one of the following three material participation tests: Test 1, Test 5, or Test 6.[7]

Second, the regulations state that an ownership interest is a "limited partnership interest" if it is designated as such in the Limited Partnership Agreement or the Certificate of Limited Partnership, regardless of whether the liability of the taxpayer holding such interest for obligations of the partnership is limited under

[1] The other two articles in the series are as follows. Sheppard, "Analyzing the Long Journey to Chaos: SECA Taxes, Limited Partner Exception, and Effects of Government Inaction," 48 Corp. Tax'n No. 6 (Nov/Dec 2021); Sheppard, "The Resurgence of IRS Disputes about Which 'Limited Partners' Escape SECA Taxes Thanks to the Section 1402(a)(13) Exception," 49 Corp. Tax'n No. 1 (Jan/Feb 2022).

[2] Section 469(a)(1)(A); Section 469(d)(1).

[3] Section 469(g).

[4] Section 469(c)(1).

[5] Reg. 1.469-5T(a).

[6] TD 8175, 53 Fed. Reg. 5686 (Feb. 25, 1988).

[7] Reg. 1.469-5T(e)(2).

applicable state law ("Formation-Documents-Label-Them-Limited-Partners Test").[8]

Third, the regulations establish that an ownership interest is a "limited partnership interest" if the liability of the taxpayer holding such interest for obligations of the partnership is limited by applicable state law to a fixed amount, such as the taxpayer's capital contribution and his contractual obligation to make additional contributions ("State-Law-Says-Liability-Is-Limited Test").[9]

Finally, the regulations establish that a *general* partner is not a *limited* partner ("General Partner Exception").[10]

A Review of Legislative History – Targeting Limited Partnerships. Neither Section 469 nor the special rules dealing with limited partnerships make much sense without some context.

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 naive actually paid their fair share.[11] To combat this problem, Congress decided to implement changes to the Internal Revenue Code in 1986, including the enactment of Section 469.[12]

This legislation placed considerable emphasis on the concept of "material participation." The rationale for the material participation rules was fairly straightforward. Congress believed 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.[13] Consequently, reasoned Congress, introducing the material participation standard would reduce the tax-reduction aspects of particular investments, while simultaneously increasing the significance of their true economic features.[14]

In its efforts to lessen tax considerations in making investments, Congress turned its focus to limited partnerships, which it labeled the vehicle of choice for tax sheltering at that time.[15] Congress left little ambiguity about its reasons for creating special rules for limited partnership interests and for authorizing the IRS to promulgate regulations in this area. The legislative history repeatedly states that IRS scrutiny should center on whether the *actions* of the relevant partners are limited, not whether their *liabilities* are limited:

> 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.[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 activities. . . .[17]

Recurrent Losses for the IRS in Various Courts. The IRS encountered serious problems when it tried to fit the proverbial square peg in a round hole, attempting to apply the "limited partner" rules to more modern entities, such as limited liability companies ("LLCs") and limited liability partnerships ("LLPs").

The number of reported court decisions and IRS rulings addressing Section 469(h)(2) and the relevant regulations was remarkably small for many years.[18] However, things accelerated starting in 2000, when the IRS suffered its first loss, followed by four more losses over the next decade. These five important cases are examined below.

Gregg v. United States – IRS Loss Number One. The taxpayer in *Gregg* was the CEO for a health care company, where he worked on a full-time basis until selling his stock in the company in 1994.[19] At the same time, the taxpayer formed Cadaja, an LLC organized under Oregon law. Two more members entered the picture soon after. The taxpayer worked a total of 100 hours at Cadaja during the initial year.

Cadaja filed a Form 1065 (U.S. Return of Partnership Income) for 1994 with the IRS showing a significant flow-through loss to the taxpayer, which is normal for a start-up business. The taxpayer reported this amount as an ordinary loss (i.e., not a passive loss) on his Form 1040 (U.S. Individual Income Tax Return). The IRS audited the taxpayer, at the con-

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8 Reg. 1.469-5T(e)(3)(i).
9 Reg. 1.469-5T(e)(3)(i).
10 Reg. 1.469-5T(e)(3)(ii).
11 S. Rep. No. 313, 99th Cong., 2d Session, 713-714 (1986).
12 Tax Reform Act of 1986 (P.L. 99-514), sections 501 and 502.
13 S. Rep. No. 313, 99th Cong., 2d Session, 716 (1986).
14 S. Rep. No. 313, 99th Cong., 2d Session, 716 (1986).
15 S. Rep. No. 313, 99th Cong., 2d Session, 720 (1986) (stating that "[t]he form of the entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership.").
16 S. Rep. No. 313, 99th Cong., 2d Session, 731 (1986).
17 H. Conf. R. No. 841, 99th Cong., 2d Sess., II-145 (1986).
18 See Ltr. Rul. 8810079 (Dec. 17, 1987); Ltr. Rul. 8827030 (July 8, 1988); *Lee*, TCM 2006-70; and *Lowe*, TCM 2008-98.
19 *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123 (DC Ore., 2000).

By contrast, when a case involves whether certain amounts from partnerships should be subject to self-employment taxes, also known as SECA taxes, the IRS argues that a tight definition of "limited partner" is appropriate.

clusion of which it issued a Notice of Deficiency recharacterizing the loss from Cadaja as a passive loss, asserting a tax deficiency, and imposing penalties. The taxpayer paid the requisite amount and filed a Claim for Refund. Once the IRS rejected it, he filed suit in District Court.

The District Court recognized the importance of this case, identifying it as one involving an "issue of first impression."[20] That issue was whether the taxpayer, who was a member of an Oregon LLC, should be considered a limited partner or a general partner in Cadaja for purposes of Section 469.[21]

The government relied on the State-Law-Says-Liability-Is-Limited Test. It suggested that the laws of Oregon extend limited liability to all members of an LLC; therefore, the taxpayer's interest in Cadaja should be treated as a limited partnership interest.[22] The taxpayer countered that the State-Law-Says-Liability-Is-Limited Test is "obsolete" when it comes to LLCs and their members, because state LLC statutes, like the one in Oregon, create "a new type of business entity that is materially distinguishable from a limited partnership."[23]

The District Court agreed with the taxpayer, basing its decision on the following foundation. First, the District 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 can have limited liability. The District Court further explained that members of an LLC retain limited liability status irrespective of their level of participation in management, while a limited partner cannot, by definition, participate in management.[24]

Second, the District Court turned to legislative history to decipher what, exactly, Congress intended upon enacting Section 469. The District 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, non-passive income.[25] The taxpayer in *Gregg* was not engaged in the type of activity that Congress aimed to thwart, said the District Court.

Finally, the District Court indicated that those in charge of promulgating regulations, the IRS, was to blame. The District Court stated the following in this regard: "In the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, [the IRS's] conclusion [that the State-Law-Says-Liability-Is-Limited Test applies] is inappropriate."[26]

Based on the preceding reasoning, the District Court ruled that legal presumption of passivity did not apply to the taxpayer, as a member of the LLC, and he could satisfy *any* one of the seven material participation tests, which he did. Accordingly, the District Court held that the pass-through loss from Cadaja was non-passive, and not subject to the passive loss restrictions on deductibility pursuant to Section 469.[27]

Garnett v. Commissioner – IRS Loss Number Two. The Tax Court addressed a similar case about a decade later. In *Garnett*, the taxpayers held interests in seven LLPs, two LLCs, and two other business ventures.[28] All these entities were formed under Iowa law.

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 Section 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 addressing whether the ownership interests in the entities were subject to the special

[20] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1127 (DC Ore., 2000).
[21] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1127 (DC Ore., 2000).
[22] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1128 (DC Ore., 2000).
[23] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1128 (DC Ore., 2000).
[24] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1128 (DC Ore., 2000).
[25] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1128 (DC Ore., 2000).
[26] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1129 (DC Ore., 2000).
[27] *Gregg*, 87 AFTR2d 2001-337, 186 F.Supp.2d 1123, 1133-1134 (DC Ore., 2000). Certain practitioners have praised the results, but not the reasoning, of this case. See Frost & 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.").
[28] *Garnett*, 132 TC 368 (2009). The taxpayers owned most of these interests indirectly through holding LLCs.

rules for limited partnerships in Section 469(h)(2).

The taxpayers advanced two main theories. First, relying on *Gregg*, they argued that the special rules under Section 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.

The Tax Court primarily focused on the second theory. It cited two portions of the legislative history, explaining the congressional reasons behind introducing the legal presumption of passivity for limited partnerships. Rooted in this history, the Tax Court reasoned that while limited liability of the partners was one characteristic of limited partners that Congress considered in enacting Section 469(h)(2), it was not, as the IRS suggested, the "sole or even determinative consideration." Rather, the Tax 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 Tax Court reasoned, no presumption that the taxpayers did not materially participate can exist.

The Tax Court then concluded that, after giving appropriate deference to the legislative purpose of Section 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."

Thompson v. United States – IRS Loss Number Three. On the heels of *Garnett* came the decision in *Thompson*.[29] Like the others, this case constituted "a question of first impression" for the Court of Federal Claims ("COFC").

The taxpayer in *Thompson* formed an LLC under Texas law. He owned directly a 99% interest in the LLC; he owned the remaining 1% indirectly through an S corporation. The taxpayer also served as 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 the losses on grounds that the taxpayer did not materially participate in the activities of the LLC, and assessed the resulting tax deficiency. In response, the taxpayer paid the requisite amount, filed a Claim for Refund, and after the IRS rejected it, filed a refund suit in the COFC. 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 government mainly advanced the State-Law-Says-Liability-Is-Limited Test because, under Texas law, the taxpayer's liability for the LLC was limited. The taxpayer, for his part, raised the same two defenses advanced by the taxpayers in *Garnett*. Namely, the special rules for limited partnerships in Section 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 because of the high degree of control he exerted over the business operations of the LLC.

The IRS encountered serious problems when it tried to fit the proverbial square peg in a round hole, attempting to apply the "limited partner" rules, specifically applicable to limited partnerships, to more modern entities, such as limited liability companies ("LLCs") and limited liability partnerships ("LLPs").

Like the District Court in *Gregg* and the Tax Court in *Garnett*, the COFC rendered a taxpayer-favorable decision in *Thompson*. However, the reasons for the outcome varied.

The COFC 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 such interest "is limited *under the law of the State in which the partnership is organized.*"[30] According to the COFC, the italicized portion literally requires that the interest be in an entity that, in fact, is a "partnership"

[29] *Thompson*, 87 Fed. Cl. Ct.728 (2009).
[30] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).

under the applicable state law, not merely taxed as a partnership for federal tax purposes. Lest any doubt remain, the COFC stated that "[t]his provision is unambiguous [therefore] the court must enforce its plain meaning."[31]

The COFC next turned its attention to the provision on which the relevant regulations are predicated, Section 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.[32] Therefore, reasoned the COFC, the taxpayer must actually be a limited partner for the provision to apply in the first place. The COFC pointed 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 COFC then highlighted the fact that the government ignored the possibility that the taxpayer met the General Partner Exception. The COFC deemed this "remarkable" considering that the regulation on which the government primarily relied specifically references the General Partner Exception as a potential saving grace. The COFC 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 COFC 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-Says-Liability-Is-Limited Test), while at the same time requesting that the COFC deny the taxpayer the benefit of the General Partner Exception. The COFC labeled this dichotomy "entirely self-serving and inconsistent."[33]

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.

Next, the COFC addressed the government's contention that the taxpayer should be considered a limited partner because at the time Section 469 was enacted, in 1986, and when the 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 COFC 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 Uniform Limited Partnership Act ("RULPA") followed in 1976. By the time Congress passed Section 469, almost all states, including Texas, had adopted one of the two. Based on its review of the ULPA and RULPA, the COFC held that "when Congress enacted [Section 469] there was general agreement among state laws that . . . a limited partner's *level of participation in the business* dictated whether or not he enjoyed limited liability."[34] The COFC turned to the surrounding statutory and regulatory framework to strengthen this conclusion. It stated that the pivotal terms in Section 469, "material participation" and "passive activity," indicate, on their face, that Congress was principally concerned with a taxpayer's degree of involvement in an activity. The COFC closed 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."[35]

A rejection of the government's argument based on legislative history was next on the COFC's agenda. It began by clarifying that there is no need to resort to legislative history in this situation because, as explained above, the pertinent statute and regulations are unambiguous. However, even if the COFC were required to review legislative history, it would favor the taxpayer, not the government. The COFC explained that the "only piece of legislative history" that aids the government is a Senate report, which purportedly authorizes the IRS to issue regulations to treat "substantially equivalent entities" as limited partnerships for purposes of Section 469(h)(2). The COFC underscored the fact that an LLC is not "substantially equivalent" to a limited partnership. For example, unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability.[36]

Finally, referring to *Garnett*, the COFC held that even if it were forced to classify the tax-

[31] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).
[32] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).
[33] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).
[34] *Thompson*, 87 Fed. Cl. Ct. 728 (2009) (emphasis added).
[35] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).
[36] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).

payer's membership 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 COFC, 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."[37]

Hegarty v. Commissioner– IRS Loss Number Four. The taxpayers in *Hegarty* had regular, full-time jobs: He was employed by a mortgage company, and she worked as a real estate salesperson.[38] In August 2003, the taxpayers decided to change course and formed an LLC under Maryland law called "Blue Marlin," through which they conducted a charter fishing business. Blue Marlin struggled financially during its first year. Its 2003 Form 1065 showed a significant net loss, which flowed from Blue Marlin to the taxpayers, who reported it on Schedule E to their Form 1040.

The taxpayers maintained a log in which they noted the time spent on each activity related to Blue Marlin, but the log was lost during their move from Maryland to Florida. The taxpayers, using receipts and other materials, reconstructed the 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 Section 469(h)(2) and the underlying regulations, took the same position that it had taken (and lost) in *Gregg*, *Garnett*, and *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 considering whether they materially participated in the business." While the taxpayers might 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 *Garnett*, the Tax Court observed that the IRS's reliance on Section 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.

Newell v. Commissioner – IRS Loss Number Five. The taxpayer in *Newell* owned a minority percent interest in Pasadera Country Club ("Pasadera"), a California LLC treated as a partnership for federal income tax purposes.[39] The taxpayer also served as Managing Member of Pasadera. He had numerous duties and responsibilities in this capacity, including hiring and firing personnel, overseeing construction of a clubhouse, administering membership programs, reviewing membership applications, issuing checks to cover operational expenses, making the annual filings for liquor licenses, handling various legal issues, and negotiating all construction and loans for Pasadera. The taxpayer was also personally liable for Pasadera's loans. 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 Pasadera were passive under Section 469, such that they were suspended. This determination by the IRS ultimately found its way into a Notice of Deficiency, which the taxpayer challenged in Tax Court.

The parties agreed before trial that the taxpayer met Test 4 of the material participation standards. This agreement notwithstanding, the IRS argued that the taxpayer cannot deduct the losses stemming from Pasadera because 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 Section 469(h)(2), the underlying regulations, and the earlier analysis in *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 limited partnership in California stands to lose his limited liability status if he gets involved in management.

Next, the Tax Court rejected the Service's contention that Section 469(h)(2) applied to the taxpayer because, for this provision to govern, 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 to a limited partnership, then the members in question

Thanks to the exception under Section 1402(a)(13), characterizing individuals as "limited partners" when making distributions from partnerships could save lots of money on SECA taxes.

[37] *Thompson*, 87 Fed. Cl. Ct. 728 (2009).
[38] *Hegarty*, TC Summ. Op. 2009-153.
[39] *Newell*, TCM 2010-23.

would more closely resemble general partners than limited partners. Narrowing this analogy, the Tax Court held that the taxpayer 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. Section 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, so he was allowed to deduct the losses in 2001, 2002, and 2003.

The IRS Finally Changes Its Tune. The string of losses by the IRS in *Gregg*, *Garnett*, *Thompson*, *Hegarty*, and *Newell* sparked lots of commentary from the tax community.[40] After suffering five major defeats on the same issue, the IRS finally changed its tune by issuing proposed regulations about Section 469(h)(2) in late 2011.[41] The preamble to such regulations contains some critical acknowledgments by the IRS:

> 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 . . . 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.[42]

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.[43] The proposed regulations also retain the requirement that an individual can only overcome the general presumption if he meets Test 1, Test 5, or Test 6.[44] In other words, the IRS did not expand the exception to allow individuals to meet *any* of the seven material participation tests. Further, the proposed regulations did little to change the existing General Partner Exception, such that individuals will still not be treated as limited partners as long as they also hold interests in general partnerships.[45]

The most notable change in the proposed regulations is the elimination of the Formation-Documents-Label-Them-Limited-Partners Test and State-Law-Says-Liability-Is-Limited Test.[46] The IRS plans to replace them with the following rules. An interest in an entity shall be treated as an interest in a limited partnership, as a limited partner, if (i) the entity is classified as a partnership for federal income tax purposes under the entity-classification regulations, *and* (ii) the holder of the interest "does not have rights to manage" the entity under the entity-formation documents and applicable state law.[47] In other words, the IRS is trying to expand the rules to cover limited partnerships, LLCs, LLPs, and more. It is also shifting its focus to determine whether an individual/partner/member has limited *actions* instead of limited *liability.*

The IRS's Position in Self-Employment Tax Cases – Narrow Interpretation

The introduction to this article explains that in cases involving whether certain distributions from partnerships should be subject to SECA taxes, the IRS argues that the concept of "limited partner" must be tightly defined. Why? Because Section 1402 indicates a "limited partner" does not need to pay SECA taxes on his distributive share of income items from a partnership. Thus, from the IRS's perspective, classifying as few persons as possible as "limited partners" is best when dealing with Section 1402.

Overview of SECA Taxes. We need to take a step back to understand the partnership distribution issue. Amounts earned by taxpayers for working generally are subject to so-called "employment

[40] See, e.g., Banoff and Lipton, "Passive Losses, LLCs and LLPs – Two Courts Reject the Service's Attempt to Limit Losses," 111 J. Tax'n No. 4 (Oct. 2009); Stevens, "After *Garnett*, *Thompson*, and *Hegarty*: LLC Members' Losses No Longer Presumed Passive?" 12 Business Entities No. 2 (Mar/Apr 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 7 (Sept. 2009).

[41] REG 109369-10, Fed. Reg. 2011-30611 (Nov. 28, 2011).

[42] REG 109369-10, Fed. Reg. 2011-30611 (Nov. 28, 2011) (emphasis added).

[43] Reg. 1.469-5T(e)(1) and Prop. 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."

[44] Prop. Reg. 1.469-5(e)(2).

[45] Prop. Reg. 1.469-5(e)(3)(ii).

[46] 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.

taxes." When dealing with "employees," they are comprised of several items, including, but not limited to, federal income taxes and Federal Insurance Contributions Act ("FICA") taxes, consisting of Social Security taxes and Medicare taxes. However, in situations involving sole proprietors, independent contractors, or partners, FICA taxes are substituted by SECA taxes.[48] For 2020, the SECA rate was 15.3% of "net earnings from self-employment," which could represent a big payment if a taxpayer is prospering.[49]

The term "net earnings from self-employment" generally means gross income derived by an individual from any trade or business carried on by such individual, minus certain business-related deductions, plus his distributive share of income or loss from any partnership in which he is a partner.[50] A number of exceptions exist. For instance, Section 1402(a)(13) excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share of any income item to a "limited partner," as a limited partner, other than certain guaranteed payments.[51]

Compliance Campaign. Thanks to the exception under Section 1402(a)(13), characterizing individuals as "limited partners" when making distributions from partnerships could save lots of money on SECA taxes. The IRS claims that this is happening frequently and inappropriately. According to the IRS, some entities treated as partnerships are classifying all members as "limited partners," thereby avoiding SECA taxes on distributions altogether. Other entities classified as partnerships are taking the position that the lion's share of the distributions are directed to "limited partners," while labeling minor amounts as wages, reporting them on Forms W-2 (Wage and Tax Statement), and subjecting them to minimal FICA taxes.

The IRS initiated a Compliance Campaign in 2018 to halt these practices, summarizing the issue as follows:

> Partners report income passed through from their partnerships. Unless an individual partner qualifies as a "limited partner" for [SECA] tax purposes, the partner's distributive share is subject to [SECA taxes]. Some individual partners, including service partners in service partnerships organized as state-law limited liability partnerships, limited partnerships, and limited liability companies, have inappropriately claimed to qualify as "limited partners" not subject to SECA tax.[52]

The IRS then introduced a Concept Unit to its personnel to assist them in implementing the Compliance Campaign. The Concept Unit contained four noteworthy items. First, it acknowledged that Section 1402(a)(3) does not define the term "limited partner," final regulations do not exist, and, therefore, IRS personnel must rely solely on legislative history and case law in making their determinations.[53]

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Second, the Concept Unit states that it applies to all entities treated as partnerships for federal tax purposes, including joint ventures, LLCs, LLPs, limited partnerships, and limited liability limited partnerships.[54]

Third, just as it did earlier in the context of the passive activity loss rules under Section 469, the Concept Unit states that "individual partners *who do not have limited liability* are subject to [SECA taxes], regardless of their participation in the partnership's business or the capital-intensive nature of the partnership's business."[55]

Fourth, the Concept Unit essentially instructed IRS personnel to act as if all five of the taxpayer-favorable decisions issued by the Tax Court, District Court, and COFC regarding limited partners and Section 469, as discussed earlier in this article, are somehow irrelevant for SECA tax purposes. Despite the

[47] With respect to entity classification, note that a business entity that is not otherwise considered a "corporation" under the applicable standards can elect its own classification for federal tax purposes. 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. This choice is memorialized by filing a Form 8832 (Entity Classification Form) with the IRS. If a domestic eligible entity with two or more members fails to make an affirmative election, the default rule generally dictates that the IRS will treat it as a "partnership." See Reg. 301.7701-3(a); Reg. 301.7701-3(c)(1)(i); Reg. 301.7701-3(b)(1).

[48] Section 1401(a) and (b); Rev. Rul. 69-184 (explaining that "remuneration received by a partner from the partnerships is not 'wages' with respect to 'employment' and therefore not subject to" FICA, federal income tax withholding, or other employment taxes).

[49] Section 1401(a) and (b).

[50] Section 1402(a).

[51] Section 1402(a)(13).

[52] *www.irs.gov/businesses/corporations/lbi-active-campaigns.*

[53] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 10.

[54] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 3.

[55] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 13 (emphasis added).

fact that both Section 469(h)(2) and Section 1402(a)(13) contain the same term, "limited partner," and they both address the same issue, the Concept Unit directed IRS personnel to simply disregard aspects that are negative for the IRS. Specifically, the Concept Unit states, without citing any support for such declaration, that "*the material participation rules under [Section] 469 have no bearing on whether an individual partner may be subject to self-employment taxes under [Section] 1402.*"[56]

The Leading Case. Many cases have wrangled with the issue of whether SECA taxes apply to certain partners or members of entities, and such cases, along with other authorities, were analyzed in two earlier articles in this series. For now, it suffices to review just the leading case, *Renkemeyer, Campbell & Weaver, LLP*, to understand the Service's position.[57]

This article highlights that the IRS takes different positions, in different contexts, regarding the same term, in an effort to maximize its tax revenue.

The taxpayers formed an LLP under Kansas law to operate their law practice ("Law Firm"). The Law Firm had three individual partners and one corporate partner in 2004. The Law Firm filed a timely Form 1065 for 2004, showing revenues primarily generated by the performance of legal services. Such revenues were distributed to the individual partners, not reported as "net earnings from self-employment" by the Law Firm, and thus not subjected to SECA taxes at the partner level.

The Law Firm amended its agreement to eliminate the corporate partner starting in 2005, to create two classes of ownership interests (i.e., General Managing Partner Interests and Investment Partner Interests), and to provide for equal allocation of distributive shares. Each of the three individual partners held both types of interests and had equal authority within the Law Firm. The LLP made distributions to the individual partners in 2005, who, again, did not pay SECA taxes on such amounts.

The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares in 2004 and 2005 as "net earnings from self-employment," not protected by the "limited partner" exception in Section 1402(a)(13), and subject to SECA taxes.

The Law Firm challenged the IRS by filing a Petition in Tax Court. The Law Firm argued that its partners, who were partners in an LLP formed in Kansas, should be treated as "limited partners" under Section 1402(a)(13) because (i) their interests are specifically called limited partner interests in the Law Firm's organizational documents, and (ii) the partners each had limited liability under Kansas law. Applying the terminology used previously in the Section 469 material participation context, the partners of the Law Firm essentially argued that they were not liable for SECA taxes because of the Formation-Documents-Label-Them-Limited-Partners Test and State-Law-Says-Liability-Is-Limited Test.

The Tax Court disagreed with the Law Firm. It began by explaining the major differences between general partners and limited partners, in terms of management power and personal liability, concluding that a limited partner interest "is generally akin to that of a passive investor."[58] The Tax Court then indicated that an LLP is a different beast; it is essentially a general partnership that affords limited liability protection to all partners. The Tax Court went on to explain that the predecessor to Section 1402(a)(13), which uses the phrase "limited partner," was enacted *before* LLPs and other modern entity forms came into existence. It then recognized that the IRS attempted to address this issue in 1997 by issuing proposed regulations, but Congress prevented the IRS from finalizing them. This was because it was "concerned that the proposed changes in the treatment of individuals who are limited partners under state law exceeds the regulatory authority [of the IRS] and would effectively [allow the IRS to] change the law administratively without congressional action."[59] In other words, Congress did not want the IRS to circumvent its legislative powers and ignore the separation-of-powers doctrine.

Without any additional guidance, the Tax Court indicated that it must engage in an exercise of statutory interpretation to determine what, exactly, Congress meant when it used the term "limited partner" in the context of SECA taxes and Section 1402(a)(13). It looked to the legislative history, which stated the following:

> Under present law, each partner's share of partnership income is includable in his net earnings from self-employment for [SECA tax] purposes, irrespective of the nature of his membership in the partnership. The bill would exclude from [SECA tax] coverage the distributive

[56] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 13 (emphasis added).

[57] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011).

[58] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 147 (2011).

[59] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 148-149 (2011) (citing the Taxpayer Relief Act of 1997, P.L. 105-34, section 935).

> share of income or loss received by a limited partner from the trade or business of a limited partnership. *This is to exclude for [SECA tax] coverage purposes certain earnings which are basically of an investment nature.*[60]

The Tax Court believed that this "insight" showed that the intent of Congress was to ensure that individuals who merely invested in a partnership and did not actively participate in its business operations would not receive credits toward Social Security coverage. It went on to explain that the legislative history does not support the notion that Congress contemplated excluding partners who performed services for a partnership, in their capacity as partners, from liability for SECA taxes.[61]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount for their partnership interests, and the distributive shares that they received in 2004 and 2005 were not, to cite the legislative history, "earnings which are basically of an investment nature." Accordingly, concluded the Tax Court, the partners must pay SECA taxes on their distributive shares and the exception under Section 1402(a)(13) does not apply.[62]

Conclusion

This article highlights that the IRS takes different positions, in different contexts, regarding the same term, in an effort to maximize its tax revenue. For instance, the IRS avidly maintained for decades that, when it comes to applying the passive activity loss-limitation rules of Section 469, the term "limited partner" should be *broadly* defined. This resulted in more determinations that taxpayers did not "materially participate" in activities, they received passive losses, and they were restricted from using such losses. The IRS clung to that position until it suffered losses in every single court in which federal tax disputes can be heard, namely, the Tax Court, District Court, and COFC.

At the same time, the IRS has argued in the past, and continues to argue in current disputes, that the concept of "limited partner" must be *narrowly* interpreted when dealing with SECA taxes and Section 1402(a)(13). This triggers more rulings that distributive shares that individuals receive from a partnership are subject to SECA taxes. The precise meaning of the term "limited partner," when it comes to limited partnerships, LLCs, LLPs and other entities is far from clear.

What is beyond doubt, though, is that the IRS intends to continue auditing and litigating these issues because it has been "fairly successful."[63] Accordingly, taxpayers holding interests in any type of pass-through entity should have a deep understanding of the pertinent terms, in every conceivable context, and utilize them to their advantage when the IRS targets them. ■

[60] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011) (citing the Social Security Amendments of 1977, P.L. 95-216, section 313(b)) (emphasis added).

[61] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011).

[62] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011).

[63] Taylor, "Clarity regarding 'Limited Partner' under SECA Remains Elusive," 2021 Tax Notes Today Federal 112-2 (June 11, 2021).