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Good News in a Bad Economy: Service Acquiesces on Pro-Taxpayer Application of Passive Activity Loss Rules to Limited Liability Companies

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I. Introduction

Four recent taxpayer victories in court,[1] the Service's acquiescence,[2] and newly issued proposed regulations[3] provide investors with yet another reason to use the increasingly popular limited liability company (LLC) form of business. These recent decisions and Service guidance have finally resolved how the passive activity loss rules apply to LLCs and have done so in a manner that significantly benefits LLC members.

The passive activity loss rules impose limitations on the deductibility of losses.[4] Given the current economic climate, many investors have experienced considerable losses. An investor's ability to currently deduct those losses could significantly impact her tax liability. Fortunately, as a result of the recent decisions and proposed regulations, many investors who use the LLC form of business can now use those losses to shelter taxable income from taxation.[5]

Under the passive activity loss rules, the characterization of an activity as active or passive has significant tax implications. Generally, a person's ability to deduct losses from a passive activity—an activity in which the taxpayer does not "materially participate"—is limited to income generated from other passive activities.[6] In contrast, losses arising from

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[1] Thompson v. United States, 87 Fed. Cl. 728 (2009); Newell v. Commissioner, 99 T.C.M. (CCH) 1107, 2010 T.C.M. (RIA) ¶ 10,023; Garnett v. Commissioner, 132 T.C. 368 (2009); Hegarty v. Commissioner, No. 3730-07S, T.C. Summ. Op. 2009-153, 2009 WL 3188789 (T.C. Oct. 6, 2009).

[2] A.O.D. 2010-02, 2010-14 I.R.B. 515.

[3] Prop. Reg. § 1.469-5, 76 Fed. Reg. 72,875 (2011).

[4] *See* I.R.C. § 469.

[5] The passive activity loss rules refer to section 469 of the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder.

[6] *See* I.R.C. § 469.

an active activity can immediately offset taxable income from *any* source, including the taxpayer's salary, wages, interest, and dividends.[7] Accordingly, nonpassive losses shelter income that may otherwise be subject to tax.

For investors using the limited partnership form of business, the correct characterization of an activity as active or passive is clear. It simply depends on whether the investor is a general partner in the business or a limited partner, who holds a presumptively passive interest.[8] But for investors using the LLC form of business, the correct characterization of an activity has been uncertain and the cause of much concern.

After nearly two decades with no guidance on the correct characterization of an LLC investor's activities for passive activity loss purposes, investors are finally receiving the answer they have patiently sought. Recently, several courts have clarified that ownership interests in LLCs are not presumptively passive limited partnership interests.[9] Instead, the more lenient general passive activity loss rules set forth in the temporary regulations apply.[10] These rules determine the active or passive nature of an activity. The Service acquiesced—in result only—and issued guidance in the form of proposed regulations, which favorably address how these rules apply to LLC members.[11]

Although this has quickly been hailed as a tremendous taxpayer victory, is this the right result, and what does it mean for investors? Part II of this Article explains the purpose and operation of the passive activity loss rules. It also explores how recent legal developments apply the passive activity loss rules to LLCs in a pro-taxpayer manner. Part III argues that the courts in the recent passive activity loss cases and the proposed passive activity loss regulations correctly apply the passive activity loss rules to LLCs. By relying on an LLC member's right to participate in the management of the entity to distinguish between limited partners and general partners, this new guidance is consistent with the passive activity loss rules' statutory framework, practical interpretation, and legislative intent. Part IV explores the implications of the recent decisions and the Service's acquiescence concerning an LLC member's self-employment tax liability, the member's ability to deduct passive activity losses from other entities when the LLC is profitable, and the tax system's economic efficiency. Finally, Part V offers a proposal for reform of the passive activity loss rules. Namely, this Article argues that Congress should treat limited partners and general partners uniformly for tax purposes.

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[7] *See* I.R.C. § 469.

[8] *See* I.R.C. § 469. However, the newly issued proposed regulations enable some limited partners in state law limited partnerships to escape classification as a limited partner for purposes of the passive activity loss rules. *See* Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

[9] *See supra* note 1.

[10] Temp. Reg. § 1.469-5T(e).

[11] A.O.D. 2010-02, 2010-14 I.R.B. 515; Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

II. Background on Passive Activity Loss Rules

A. *General Application*

1. *Purpose of the Rules*

Prior to 1986, many investors sought to reduce their tax liability by investing in businesses that generated tax losses. The investors would use these tax losses to shelter their taxable income from taxation. Often, investors would not take into account whether their investments had the potential to produce any economic profit.[12] Instead, their primary focus was the investment's tax benefits.

In 1986, in an attempt to eliminate the prevalence of these tax shelters, Congress enacted section 469—commonly known as the passive activity loss rules.[13] Congress was concerned with taxpayers' ability to significantly reduce their tax liability with deductions and credits attributable to losses that lacked economic reality.[14] Through section 469, Congress hoped to encourage investments based on nontax economic profit motives.

2. *General Rule*

Section 469 generally disallows the deduction of losses from passive activities against nonpassive income and limits the use of credits from passive activities to the tax allocable to the passive activities.[15] Losses from passive activities cannot offset income such as salaries, interest, dividends, gains from sale of stock and other capital assets, or net income from a business in which the taxpayer actively participates.[16] The disallowed losses and credits are carried

[12] Specifically, taxpayers were choosing investments that offered opportunities to reduce or avoid their tax liability with respect to wages and other positive income sources. Such opportunities included the tax deductions and credits provided by an investment and frequently exceeded the taxpayer's real economic costs or losses—if any. The deductions also were generally available prior to the taxpayer earning any income from the investment. S. REP. NO. 99-313, at 714 (1986); *see* Robert J. Peroni, *A Policy Critique of The Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1998).

[13] Congress believed section 469 was necessary to eliminate tax shelters, because the limitations on the deductibility of losses existing at the time of section 469's enactment were insufficient. For instance, the at-risk limitations on the deductibility of losses under section 465—which was previously enacted to address the tax shelter problem—did not prevent investors from sheltering positive income through deductions and credits attributable to passive income sources. According to Congress, "the fact that a taxpayer is potentially liable with respect to future expenses or losses of the activity . . . has no bearing on the question of whether any amount has as yet been lost, or otherwise is an appropriate current deduction or credit." S. REP. NO. 99-313, at 713, 717 (1986).

[14] *Id.* at 713. The prevalence of tax shelters was of great concern to Congress, not only because of the loss of government revenue, but also because it created a common perception that the tax system is unfair. This perception generally undermines compliance with the tax system and encourages further growth of the tax shelter market and an inefficient use of assets. *Id.* at 714.

[15] I.R.C. § 469(a), (d); Temp. Reg. §§ 1.469-1T(a), -2T(b), -3T(a).

[16] I.R.C. § 469(a), (d).

over to and deducted in future years when passive income exists or when the taxpayer disposes of the passive activity that generated the passive activity losses.[17]

For purposes of section 469, a "passive activity" is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.[18] Accordingly, the amount of time a taxpayer participates in a trade or business is critically important in determining whether that taxpayer can currently deduct any losses attributable to the activity.

3. *Material Participation Standard*

Under the passive activity loss rules, an investor materially participates in an activity only if she is involved in the activity's operations on a regular, continuous, and substantial basis.[19] For these purposes, the investor's status as a general partner or a limited partner makes a significant difference.

General partners, S corporation shareholders, and certain other investors who are not limited partners may use seven alternative mechanical tests set forth in the temporary regulations to establish material participation in an activity.[20] Specifically, these investors may satisfy the material participation requirement for the taxable year by demonstrating any of the following: (1) the investor participated in the activity for more than 500 hours during that year;[21] (2) the investor's participation in the activity for the taxable year constituted substantially all of the participation of all individuals in the activity for that year—including those individuals who are not owners of interests

[17] I.R.C. § 469(b). This treatment is consistent with the underlying theory of the passive activity loss rules. The premise of these rules is that in a given year, a taxpayer's loss from a passive activity does not reflect the taxpayer's actual economic loss for that year. Instead, the taxpayer's actual loss can be accurately measured only when the taxpayer disposes of her entire interest in the passive activity. *See* Peroni, *supra* note 12, at 2–3 (citing S. Rep. No. 99-313, 713, 716–17 (1986)).

[18] I.R.C. § 469(c)(1). Congress regarded material participation in an activity as an indication that an investment has a significant nontax economic profit motive instead of an investment made primarily to produce a tax loss. According to the Senate Report, a material participation standard distinguishes between different types of taxpayer activities on the basis that a taxpayer who materially participates in an activity is more likely to consider whether an activity has genuine economic significance and value. On the contrary, a passive investor, who does not materially participate in the activity, is seeking a return on capital invested. This return on capital includes returns in the form of lower taxes on unrelated income. S. Rep. No. 99-313, at 713, 716–17 (1986).

In certain circumstances, Congress regarded material participation as irrelevant in determining the active or passive nature of an activity. For instance, a rental activity is generally a passive activity regardless of whether the taxpayer materially participates in the activity in a given taxable year. I.R.C. § 469(c)(2), (4). Similarly, the term "passive activity" does not include certain working interests in oil and gas properties. I.R.C. § 469(c)(3), (4).

[19] I.R.C. § 469(h)(1). In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer is also taken into account. I.R.C. § 469(h)(5).

[20] Temp. Reg. § 1.469-5T(a).

[21] Temp. Reg. § 1.469-5T(a)(1).

in the activity;[22] (3) the investor participated in the activity for more than 100 hours during the year, and the investor's participation was not less than any other person's participation in the activity that year;[23] (4) the activity is a significant participation activity,[24] and the investor's aggregate participation in all significant participation activities during that year exceeded 500 hours;[25] (5) the investor materially participated for any five taxable years during the ten taxable years immediately preceding the current taxable year;[26] (6) the activity is a personal service activity,[27] and the investor materially participated for any three taxable years preceding the taxable year;[28] or (7) based on all the facts and circumstances—after taking into account certain limitations—the investor participated in the activity on a regular, continuous, and substantial basis during that year.[29]

The above tests do not apply to limited partners. If a taxpayer holds an "interest in a limited partnership as a limited partner," section 469(h)(2) presumes the taxpayer did not materially participate in the activity of the partnership—the activity is a per se passive activity.[30] This is often referred to as the passive activity presumption.

An investor holding a limited partnership interest may overcome this passive activity presumption in one of two ways. First, if the investor is also a general partner in the partnership, the passive activity presumption does not apply—the "general partner exception."[31]

Second, if the investor satisfies test (1), (5), or (6) of the material participation standard described above, the investor can overcome the passive activity presumption.[32] Therefore, a limited partner who is not also a general partner in the partnership can satisfy the material participation standard by participating in an activity for more than 500 hours during the year, materially

[22] Temp. Reg. § 1.469-5T(a)(2).

[23] Temp. Reg. § 1.469-5T(a)(3).

[24] A significant participation activity is an activity that is a trade or business activity in which the individual significantly participates—participates for more than 100 hours—for the taxable year but does not materially participate for such year—determined without regard to this material participation test. Temp. Reg. § 1.469-5T(c).

[25] Temp. Reg. § 1.469-5T(a)(4).

[26] Temp. Reg. § 1.469-5T(a)(5).

[27] For these purposes, an activity constitutes a personal service activity if such activity involves "the performance of personal services in the fields of health, law, engineering, architecture, actuarial science, performing arts or consulting; or any other trade or business in which capital is not a material income-producing factor." Temp. Reg. § 1.469-5T(d).

[28] Temp. Reg. § 1.469-5T(a)(6).

[29] Temp. Reg. § 1.469-5T(a)(7).

[30] I.R.C. § 469(h)(2) ("[E]xcept as provided in 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.").

[31] Temp. Reg. § 1.469-5T(e)(3)(ii) (providing that an individual that is a general partner is not treated as holding a limited partnership interest even if such individual is also a limited partner in the partnership).

[32] Temp. Reg. § 1.469-5T(e)(2).

participating in the activity for any five taxable years during the ten taxable years immediately preceding the current taxable year, or materially participating in the activity for any of the three preceding taxable years—provided the activity is a personal service activity.[33] Limited partners cannot use the other, more lenient material participation tests—such as the 100-hour test described above—to establish material participation.[34]

B. *Application of Passive Activity Presumption to Limited Liability Companies*

As the popularity of LLCs has continued to increase, so have investors' concerns about how the passive activity loss rules apply to LLCs. But Congress did not have LLCs in mind when it enacted section 469.[35] Accordingly, the statute and corresponding regulations do not specifically address LLCs.

As with other statutes, this statutory omission, in itself, is insufficient to shelter LLCs from the reach of section 469.[36] It is commonly agreed that LLC members are subject to the passive activity loss rules. The literal terms of section 469 apply the passive activity loss rules to LLC members—section 469 expressly states that the passive activity loss rules apply to individuals, estates, trusts, closely held C corporations, and personal service corporations, which generate losses or credits through a passive activity.[37] Because the statute imposes the passive activity loss rules at the individual level and LLCs are generally taxed as conduits, LLC members are subject to the general loss limitations of section 469.

Even though LLC members are subject to the passive activity loss rules, it has not been clear until recently whether the passive activity presumption also applies to LLC members. As discussed below, recent case law and the proposed regulations—to a lesser extent—have finally resolved this uncertainty in favor of LLC members.

1. *In General*

LLC members who want to deduct losses from an LLC confront the following question: does an LLC member hold an "interest in a limited partner-

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[33]Temp. Reg. § 1.469-5T(e)(2).

[34]Temp. Reg. § 1.469-5T(e)(3).

[35]Garnett v. Commissioner, 132 T.C. 368 (2009) (citing ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 1.01(b)(4), (5) (1998) (stating that "it is doubtful that Congress had L.L.C.s specifically in mind [when it enacted Section 469(h)(2) in 1986], since only one State, Wyoming, had an L.L.C. statute in 1986")).

[36]For example, certain statutes and regulations include a catchall provision that can apply to LLCs through reasonable interpretation. Also, when a statute or regulation mentions only a few organizations or provides different treatment for corporations and partnerships, courts often identify the policies the statute seeks to advance, decide what aspects of an LLC are most relevant to those policies, and include or exclude LLCs from the statute accordingly. *See* CARTER G. BISHOP & DANIEL KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.03[1][a] (2010) (referring to Article 9 of the Uniform Commercial Code).

[37]I.R.C. § 469(a).

ship as a limited partner"?[38] The answer to this question substantially affects the tax liability of many LLC members. For this reason, investors have been greatly concerned with the passive activity presumption's potential application to LLC members.

If the answer to the above question were yes, an investor who did not participate in the investment for more than 500 hours during the year would often be unable to deduct losses attributable to the LLC that year.[39] For instance, consider an attorney who works in a law practice and also works 110 hours in an art business conducted through an LLC. If the tax law treats the attorney in the same manner as a limited partner with respect to the art business, the attorney generally would be unable to deduct the art business losses against the income attributable to the attorney's law practice.

The losses are not currently deductible because the attorney did not participate in the art business for more than 500 hours during the year. Instead, the losses are suspended and are of no use to the attorney until the art business or the attorney's other passive activities generates sufficient profits to allow her to deduct the suspended losses. Alternatively, the attorney could use the suspended losses when she disposes of her interest in the art business.

On the other hand, if the answer to the above question were no, an LLC member would not hold an interest in a limited partnership as a limited partner, so section 469(h)(2) would not apply.[40] Thus, an LLC member would be able to establish material participation through any of the seven mechanical tests set forth in the temporary regulations.[41]

If section 469(h)(2) were inapplicable, the attorney in the example above would most likely be able to immediately deduct the art business losses against his law practice earnings and against any portfolio income. Even though the attorney did not participate in the art business for more than 500 hours during the year, the attorney would likely satisfy the material participation standard. The attorney, who participated in the art business for more than 100 hours during the year, could satisfy the material participation standard with respect to the art business by establishing that she participated in the art business at least the same amount as any other person that year. Alternatively, the attorney could satisfy the material participation standard by proving that her participation in the art business constituted substantially all of the participation in the art business for all individuals during the taxable year.

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[38] I.R.C. § 469(h)(2).

[39] This conclusion is based on the assumption that the investor did not materially participate for any five taxable years during the ten taxable years immediately preceding the current taxable year, and that if the activity is a personal service activity, the taxpayer did not materially participate for any of the three preceding taxable years. *See* Temp. Reg. § 1.469-5T(a). This conclusion is also based on the assumption that the investor does not have passive income from other investments that can otherwise offset the passive losses and that the attorney is not also a general partner in the art business. *See* Temp. Reg. § 1.469-5T(e)(3)(ii).

[40] *See* I.R.C. § 469(h)(2).

[41] *See* Temp. Reg. § 1.469-5T(a).

Until recently, disregarding the passive activity presumption was a risky endeavor for LLC members. A literal reading of the statute and the corresponding temporary regulations did not clearly address whether the passive activity presumption were applicable to LLC members. But, in applying the passive activity loss rules, the Service took the position that the passive activity presumption should apply in the LLC context.[42] Therefore, the Service's position made it more difficult for LLC members—like limited partners—to establish material participation. As illustrated in the above example, extending the passive activity presumption to LLC members substantially limits the immediate deductibility of LLC losses.

2. *Cases*

For many years, investors and tax practitioners were left to determine the correct application of the passive activity loss rules with only the current statute, the corresponding Treasury regulations, and the legislative history as guidance. In 2000, *Gregg v. United States* provided the first, although limited, direct guidance to investors on the application of the passive activity loss rules to LLC members.[43] Subsequently, beginning in 2009, four more cases addressing the issue were decided. These decisions finally clarified the correct application of the passive activity loss rules to LLC members and prompted the Treasury Department to issue guidance on this matter.[44] The following subsections discuss these cases, the Service's acquiescence in 2010, and the newly issued proposed passive activity loss regulations.

a. Gregg v. United States. In *Gregg*, the taxpayer, a member of an Oregon LLC taxed as a partnership for federal income tax purposes, claimed his ratable share of the LLC's flow-through operating losses as an ordinary loss on his income tax return.[45] The Service treated the taxpayer as a limited partner for purposes of the passive activity loss rules and applied the passive activity presumption to recharacterize the loss as a passive activity loss.[46]

According to the Service, in the absence of a specific designation in the partnership agreement or certificate, the question of whether a partner-

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[42] Prior to *Gregg v. United States*, decided in 2000, no cases discussed the application of the passive activity presumption in the context of LLCs. Based on the Service's position in *Gregg* and the more recent decisions, it is likely that the Service took the same position when addressing this issue with taxpayers directly. *See* Gregg v. United States, 186 F. Supp. 2d 1123 (D. Or. 2000); Thompson v. United States, 87 Fed. Cl. 728 (2009); Newell v. Commissioner, 99 T.C.M. (CCH) 1107, 2010 T.C.M. (RIA) ¶ 10,023; Garnett v. Commissioner, 132 T.C. 368 (2009); Hegarty v. Commissioner, No. 3730-07S, T.C. Summ. Op. 2009-153, 2009 WL 3188789 (T.C. Oct. 6, 2009).

[43] 186 F. Supp. 2d at 1123.

[44] *Thompson*, 87 Fed. Cl. at 728; *Newell*, 99 T.C.M. (CCH) at 1110–12, 2010 T.C.M. (RIA) ¶ 10,023 at 157–59; *Garnett*, 132 T.C. at 378–81; *Hegarty*, 2009 WL 3188789, at *2–3.

[45] *Gregg*, 186 F. Supp. 2d at 1125. The limited liability company in *Gregg* was an Oregon service company that provided consulting, marketing, networking, and business services in the alternative medicine and alternative health care industry.

[46] *Id.* at 1125–26, 1128.

ship interest is limited or general depends on whether limited liability exists under state law.[47] Because Oregon's law and the company's operating agreement extended limited liability protection to the LLC's members—under the Service's reasoning—the taxpayer's interest in the company constituted an interest in a limited partnership as a limited partner for section 469 purposes.[48] Thus, the Service treated the taxpayer's interest in the limited liability company as a per se passive interest.[49]

But, the court in *Gregg* rejected the Service's arguments. According to the court, the question of whether a partnership interest is limited or general depends on whether an investor may participate in the management of the business.[50] On this basis, the court held that the taxpayer did not hold an interest in a limited partnership as a limited partner.[51]

Specifically, the court concluded that the limited partnership presumption is not applicable to LLC members because LLCs are designed to permit active involvement by LLC members in the company's management.[52] Oregon's statute defines a general partner interest as an interest of a partner who is not subject to restrictions upon participation in the business.[53] No such restrictions existed in either the operating agreement with respect to the taxpayer or in Oregon's LLC statute.[54] Thus, the taxpayer held his interest as a general partner.[55] As a general partner's interest, the taxpayer's interest in the LLC was not subject to the passive activity presumption applicable to limited partnership interests.[56]

b. Garnett v. Commissioner. Subsequently, in 2009, the Service lost three more court challenges related to the treatment of LLC members

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[47] *Id.* at 1128.

[48] *Id.*

[49] *Id.* at 1123. The taxpayer disagreed with the Service's characterization of the loss, arguing that the passive activity presumption did not apply. Oregon law defines a general partnership interest in terms of an individual who is not restricted from participation in the control of the business. Because the taxpayer was not subject to any such restriction, the taxpayer asserted that, by definition, he was a general partner.

[50] *Id.* at 1128.

[51] *Id.* at 1129.

[52] *Id.* at 1128.

[53] *Id.* Specifically, the Oregon statute states that "except as provided in [Oregon's limited partnership statute] or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners." OR. REV. STAT. § 70.185(1) (2011).

[54] *Gregg*, 186 F. Supp. 2d at 1127–28.

[55] *Id.* at 1133–34.

[56] *Id.* at 1129. The Service also argued that Oregon law is preempted and does not apply, except as otherwise directed by the provisions of section 469 and the corresponding Treasury regulations. *Id.* at 1128. The court rejected this argument, along with the Service's other arguments, holding that the Service's conclusion was inappropriate in the absence of any Treasury regulation asserting that an LLC member should be treated as a limited partner of a limited partnership. *Id.*

under the passive activity loss rules.[57] These cases significantly weakened the Service's position that the passive activity presumption automatically applies to LLC members.

In *Garnett*, the first case addressing the issue in nearly nine years, the Service disallowed the ordinary losses claimed by members of limited liability entities.[58] Several of these entities incurred losses during the taxable years in question.[59] The taxpayers claimed the losses as ordinary losses on their tax returns because they satisfied the general material participation tests.[60]

The taxpayers in *Garnett* owned direct and indirect interests in numerous limited liability partnerships (LLPs) and LLCs formed under Iowa law and engaged in the production of poultry, eggs, and hogs.[61] Pursuant to the agreements governing the entities, each LLP partner could actively participate in the control, management, and direction of the partnership business. The agreements also specified that no partner was liable for the LLPs' liabilities unless required under Iowa law. In addition, one taxpayer had exclusive authority to act for two of the LLCs and on behalf of the members as the LLCs' sole manager.[62]

According to the Service, *Gregg* was incorrectly decided and the taxpayers should be subject to the passive activity presumption.[63] In arguing that the passive activity presumption applied to the taxpayers, the Service claimed the sole relevant consideration is the taxpayers' limited liability with respect to their ownership interests.[64] Even though the Service conceded that the general partner exception to the passive activity presumption is not categorically unavailable to LLP partners or LLC members, it also claimed that the exception's availability is based on a separate factual inquiry into the nature and

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[57] Thompson v. United States, 87 Fed. Cl. 728 (2009); Garnett v. Commissioner, 132 T.C. 368 (2009); Hegarty v. Commissioner, No. 3730-07S, T.C. Summ. Op. 2009-153, 2009 WL 3188789 (T.C. Oct. 6, 2009).

[58] *Garnett*, 132 T.C. at 371.

[59] *Id.*

[60] *Id.* Relying upon *Gregg*, the taxpayers argued that the passive activity presumption applicable to limited partners should not apply because the companies were not limited partnerships under state law and the taxpayers were more akin to general partners of the companies—rather than limited partners. *Id.* at 374.

[61] *Id.* at 369–70.

[62] *Id.* at 370–71. The court documents did not specify the scope or types of activities provided by the taxpayers.

[63] *Id.* at 374.

[64] *Id.* at 376. The Service contended that the differences existing among limited partnerships, LLPs, and LLCs are irrelevant under the temporary regulations.

extent of the taxpayer's authority to act on behalf of the entities.[65] Because the taxpayers were limited partners who did not overcome the passive activity presumption or satisfy the general partner exception, the Service disallowed these loss deductions.[66]

The Tax Court—not persuaded by the Service's arguments—held for the taxpayers.[67] As in *Gregg*, the court refused to consider limited liability as the determinative factor in applying the passive activity presumption.[68] Because investors in LLPs and LLCs are not necessarily constrained from participating in the management of such entities, the court concluded that it is inaccurate to presume that such investors are not materially participating in the entities.[69]

Therefore, the court held that the taxpayers' ability to participate in the management of the LLPs and the LLCs was sufficient to treat them as general partners for purposes of section 469(h)(2).[70] As general partners, the taxpayers' interests in the companies were exempt from classification as limited partnership interests and subject to the more lenient material participation tests.[71]

The court also rejected the Service's suggestion of making a separate threshold factual inquiry to determine general partner status. According to the court, this additional step would be inconsistent with the statutory framework and legislative intent of the passive activity loss rules.[72] Thus, the taxpayers could establish material participation in the entities through any of the seven tests set forth in the temporary regulations.[73]

c. Thompson v. United States. Only a few weeks after the Tax Court decided *Garnett*, the U.S. Court of Federal Claims faced the same issue—whether a membership interest in an LLC taxed as a partnership is a limited partnership interest for purposes of the passive activity loss rules.[74]

[65] *Id.* at 378–79. According to the Service, based on a separate factual inquiry, the general partner exception did not apply in *Garnett* because the partnership agreements did not give the taxpayers authority to take action on behalf of the entities in the same manner as a general partner. The taxpayers also did not function as if they were general partners. Even though the taxpayers were not precluded under Iowa law from actively participating in the management and operations of the companies, the Service found this fact insufficient to establish the taxpayers' status as general partners for purposes of the general partner exception. *Id.* at 379.

[66] *Id.* at 369–70.

[67] *Id.* at 381.

[68] *Id.* at 380.

[69] *Id.* at 376.

[70] *Id.* at 379–81.

[71] *Id.*

[72] *Id.* at 379. Even though it is necessary to examine the facts and circumstances to ascertain the nature and extent of a taxpayer's participation in an entity's business, the court concluded that this factual inquiry is more appropriately made pursuant to the general tests for material participation under section 469 and the corresponding Treasury regulations. *Id.* at 380.

[73] *Id.* at 372.

[74] Thompson v. United States, 87 Fed. Cl. 728, 730 (2009).

In *Thompson*, the taxpayer structured his business activity in the form of an LLC under the laws of the State of Texas and elected partnership taxation.[75] The taxpayer owned a 99% membership interest in the LLC and served as the sole manager. In this case of first impression, the U.S. Court of Federal Claims—like the Tax Court—rejected the Service's position.[76] The court disagreed with the Service's application of the passive activity presumption to the taxpayer's LLC interest.[77]

The Service used many of the same arguments in claiming it was proper to treat the taxpayer's interest as a limited partnership interest for purposes of section 469(h)(2).[78] As in *Gregg* and *Garnett*, the Service asserted that (1) because the taxpayer's liability is limited under the laws of the State of Texas, the state in which it was organized, the taxpayer's interest in the LLC constituted an interest in a limited partnership as a limited partner, and (2) the dividing line between interests of limited partners and general partners is the presence or absence of limited liability.[79]

In rejecting the Service's tax assessment, the court based its holding on the plain language of the temporary regulations.[80] According to the court, the temporary regulations apply the passive activity presumption only to entities that are in fact partnerships under state law and not entities that merely elect to be taxed as such.[81] Similarly, after examining section 469(h)(2), the court concluded that section 469(h)(2) literally limits the application of the passive activity presumption to taxpayers who actually constitute limited part-

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[75] *Id.* at 729.

[76] *Id.* at 730.

[77] *Id.* at 734.

[78] *Id.* at 735–36. The Service also introduced a new argument to support its claim, which the court rejected. The Service asserted that the taxpayer should be treated as a limited partner for purposes of section 469(h)(2) because the taxpayer elected to have the LLC taxed as a partnership for federal income tax purposes. *Id.* at 733.

[79] *Id.* at 733–35. The taxpayer used the same arguments used by the taxpayers in *Gregg* and *Garnett*. Specifically, the taxpayer argued that his ownership interest could not be that of a limited partner because the LLC is not a limited partnership under state law. Furthermore, even if the LLC could be properly analogized to a limited partnership, the taxpayer's interest is more akin to that of a general partner's interest.

[80] *Id.*

[81] *Id.* (quoting Temp. Reg. § 1.469-5T(e)(3)(i)(B), which states that "a partnership interest shall be treated as a limited partnership interest if . . . [t]he liability of the holder of such interest for obligations of the partnership is limited, ***under the laws of the State in which the partnership is organized***." (emphasis added by the court in *Thompson*)). The court reasoned that because the provision in the Treasury regulations is unambiguous, it must enforce its plain meaning under the rules of statutory construction.

ners under state law.[82] Based on this reasoning, the court concluded that the limited partner presumption did not apply. Thus, the taxpayer in *Thompson*, a member and manager of an LLC, was not a limited partner of a partnership.[83]

By citing *Garnett*, the court also held that even if an LLC is treated as a limited partnership, LLC members could avoid section 469(h)(2) under the general partner exception.[84] The key feature or attribute differentiating between a general partner interest and limited partner interest is the ability of a general partner to participate in the control of the business.[85] The limited liability feature of limited partners is irrelevant.[86]

As an LLC member, the taxpayer did not hold a per se passive interest and could establish material participation under the more extensive material participation tests available to general partners.[87] Hence, *Thompson* joined *Garnett* and *Gregg* as the third recent case to rule against the Service's application of section 469(h)(2) to LLC members.

d. Hegarty v. Commissioner. Less than three months after the U.S. Court of Federal Claims decided *Thompson*, the Tax Court issued a summary opinion in *Hegarty v. Commissioner* that treated the LLC members in that case as general partners for purposes of the passive activity loss rules.[88]

In *Hegarty*, a husband and wife each owned a 50% interest in a Maryland LLC organized to conduct charter fishing activities.[89] According to the evidence, the taxpayers' participation in the business exceeded 100 hours but was less than 500 hours during the taxable year in question.[90]

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[82] *Id.* (emphasizing the following italicized language in section 469(h)(2) as relevant: "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"). The court's reasoning differs from that of the court in *Garnett*, which rejected the argument that the term "limited partner" should be interpreted literally to mean "nothing more nor less than a limited partner in an entity that is classified as a limited partnership under applicable state law." Garnett v. Commissioner, 132 T.C. 368, 377 (2009).

[83] *Thompson*, 87 Fed. Cl. at 734–35.

[84] *Id.* at 728. According to the court, the Service's argument disregarded the fact that even though an LLC member could hold a limited partner's interest under the Code and Treasury regulations, that same member could also hold a general partner interest and thereby come within the general partner exception.

[85] *Id.* at 735–36.

[86] *Id.* at 726. This conclusion is consistent with the statutory and regulatory framework, as well as the legislative history relating to section 469, which indicates that Congress did not care about the taxpayer's level of liability in enacting section 469(h)(2). *See infra* Part III.

[87] *Thompson*, 87 Fed. Cl. at 726.

[88] Hegarty v. Commissioner, No. 3730-07S, T.C. Summ. Op. 2009-153, 2009 WL 3188789, at *3 (T.C. Oct. 6, 2009).

[89] *Id.* at *1.

[90] *Id.*

The Service disallowed the taxpayers' deduction of the LLC's losses.[91] According to the Service, the business was conducted through an LLC, and therefore, the taxpayers should be "treated as limited partners in considering whether they materially participated in the business."[92] The taxpayers were unable to overcome the passive activity presumption because they participated in the business for less than 500 hours during the taxable year.[93]

In relying upon *Garnett*, the Tax Court disagreed with the Service and held that the Service's reliance on the passive activity presumption was misplaced.[94] The Tax Court concluded that a taxpayer's material participation in a business conducted through an LLC could be established through any of the seven tests set forth in the temporary regulations.[95] Under these tests, even though the taxpayers worked less than 500 hours during the taxable year, they could satisfy the material participation standard.[96] Specifically, by establishing that they worked in the business for more than 100 hours during the taxable year and at least as many hours as any other individual during that year, the taxpayers demonstrated that they materially participated in the business.[97]

e. Newell v. Commissioner. Despite these clear taxpayer victories, the Service continued to take the hardline position that an LLC interest is a limited partnership interest for purposes of the passive activity loss rules. In 2010, the Service again attempted and failed to defend its position in *Newell v. Commissioner*.[98]

In *Newell*, the taxpayer owned a 33% membership interest in an LLC formed under California law and classified as a partnership for federal income tax purposes.[99] The taxpayer also served as the managing member of the LLC, which was in the business of owning and operating a golf course, a restaurant, and a country club facility.[100] As the managing member, the taxpayer actively engaged in the conduct of the business of the LLC for 450 hours in 2001, 400 hours in 2002, and 400 hours in 2003.[101] The taxpayer claimed the LLC's losses as ordinary losses on his tax return.[102]

Once again, the Service treated the taxpayer's interest in the LLC as a limited partnership interest, applied the passive activity presumption, and dis-

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[91] *Id.*
[92] *Id.* at *2.
[93] *Id.*
[94] *Id.* at *2–3.
[95] *Id.* at *2.
[96] *Id.* at *2–3.
[97] *Id.* at *3; Temp. Reg. § 1.469-5T(a)(3).
[98] 99 T.C.M. (CCH) 1107, 2010 T.C.M. (RIA) ¶ 10-023.
[99] *Id.* at 1108, 2010 T.C.M. (RIA) ¶ 10-023 at 154.
[100] *Id.*
[101] *Id.* at 1109, 2010 T.C.M. (RIA) ¶ 10-023 at 155.
[102] *Id.*

allowed the losses.[103] As in *Garnett* and in *Hegarty*, the Tax Court rejected the Service's argument and concluded section 469(h)(2) did not apply.[104] According to the Tax Court, the taxpayer's interest in the LLC was an interest held as a general partner, and therefore, the taxpayer was within the general partner exception to the passive activity presumption.[105]

In reaching this conclusion, the Tax Court considered that LLC members could participate in the management of an LLC under California law and that the LLC's operating agreement also authorized the managing member to participate in the management of the LLC.[106] Because of these factors, the Tax Court concluded, "[I]f we analogize a California L.L.C. to a limited partnership, the members of a California L.L.C. more closely resemble general partners than limited partners."[107]

The Tax Court also determined that the facts in *Newell* provided an even more compelling basis than the facts in *Garnett* for treating the taxpayer as a general partner.[108] In *Garnett*, the Tax Court concluded that the taxpayer constituted a general partner even though the taxpayers' exact roles in the management of the LLCs were not described.[109]

On the other hand, in *Newell*, the taxpayer's role as the managing member was described in detail.[110] The taxpayer's activities adequately illustrated that he functioned as the substantial equivalent of a general partner in a limited partnership.[111] Even the Service conceded that the taxpayer substantially participated in managing the LLC as its managing member.[112] Thus, as in *Garnett*, the general, less restrictive, material participation tests were applied in *Newell* to determine the taxpayer's material participation in the business.[113]

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[103] *Id.* (citing to Temp. Treas. Reg. § 1.469-5T(e)(3)(i)(B), which provides that a partnership interest shall be treated as a limited partnership interest if "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").

[104] *Id.* at 1111, 2010 T.C.M. (RIA) ¶ 10-023 at 158.

[105] *Id.* at 1111–12, 2010 T.C.M. (RIA) ¶ 10-023 at 158–59.

[106] *Id.* at 1110–11, 2010 T.C.M. (RIA) ¶ 10-023 at 157, 159 (citing CAL. CORP. CODE § 17150 (West 2006), which also provides that no member of an LLC is personally liable for any debt, obligation, or liability of the LLC solely by reason of being a member thereof).

[107] *Id.* at 1111, 2010 T.C.M. (RIA) ¶ 10-023 at 158.

[108] *Id.* at 1111, 2010 T.C.M. (RIA) ¶ 10-023 at 158–59.

[109] *See* Garnett v. Commissioner, 132 T.C. 368, 380–82 (2009).

[110] *See Newell*, 99 T.C.M. (CCH) at 1111–12, 2010 T.C.M. (RIA) ¶ 10,023 at 159. In *Newell*, the taxpayer, as the managing member, was responsible for hiring and firing all management personnel, overseeing the construction of the company's clubhouse, creating and administering all membership programs—including advertising and reviewing and approving membership applications—and reviewing, approving, and signing all checks for expenses incurred in the construction and operation of the business. The taxpayer was also personally liable for the company's construction and permanent loans, which he negotiated on behalf of the company.

[111] *Id.*

[112] *Id.* at 1111, 2010 T.C.M. (RIA) ¶ 10-023 at 158.

[113] *See id.* at 1111–12, 2010 T.C.M. (RIA) ¶ 10-023 at 158–59.

3. *Service Acquiescence*

After this string of losses in court, the Service acquiesced in April 2010 to the court's holding in *Thompson*, although it acquiesced in result only.[114] The Service accepted the court's holding that the taxpayer's LLC interest in that particular instance was not equivalent to a limited partnership interest for purposes of section 469(h)(2).[115] However, unlike the U.S. Court of Federal Claims in *Thompson*, the Service—in its acquiescence—did not address whether the taxpayer's interest could be categorized as a general partner interest if the interest were treated as an interest in a limited partnership.[116]

4. *Proposed Regulations*

On November 28, 2011, the Service finally issued proposed regulations that provide guidance on whether the passive activity presumption applies to LLC members.[117] The proposed regulations would modify the definition of a limited partner for purposes of the passive activity loss rules. Specifically, the proposed regulations provide that an interest in an entity constitutes an interest in a limited partnership as a limited partner if two requirements are met: (1) the entity is classified as a partnership for federal income tax purposes, and (2) the interest holder does not have "rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement."[118] According to the Preamble to the proposed regulations, the right to manage the entity also "include[s] the power to bind the entity."[119] Thus, if both requirements were met, an interest holder would be subject to the passive activity presumption under the proposed regulations.

The proposed regulations would therefore "eliminate the current regulations' reliance on limited liability" to distinguish between limited partners and general partners for purposes of section 469(h)(2).[120] This approach is consistent with the approach taken by the courts in the recent passive activity loss cases, which also refuse to differentiate between limited partners and general partners on the basis of limited liability.[121]

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[114]A.O.D. 2010-002, 2010-14 I.R.B. 515.

[115]*Id.*

[116]*See id.*

[117]*See* Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

[118]Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

[119]Preamble to Prop. Reg. § 1.469-5, 76 Fed. Reg. 72,875, 72,876 (2011).

[120]Preamble to Prop. Reg. § 1.469-5, 76 Fed. Reg. 72,875, 72,877 (2011); Temp. Reg. § 1.469-5T(e)(3)(i)(providing that a partnership interest is a limited partnership interest if (1) the interest is designated as a limited partnership interest in the partnership agreement or certificate of limited partnership, or (2) the interest holder has limited liability for the partnership obligations under State law to a determinable fixed amount).

[121]*See* Thompson v. United States, 87 Fed. Cl. 728 (2009); Newell v. Commissioner, 99 T.C.M. (CCH) 1107, 2010 T.C.M. (RIA) ¶ 10,023; Garnett v. Commissioner, 132 T.C. 368 (2009); Hegarty v. Commissioner, No. 3730-07S, T.C. Summ. Op. 2009-153, 2009 WL 3188789 (T.C. Oct. 6, 2009).

But the proposed regulations also differ from the approach advocated by the court in *Thompson* and *Gregg*. The proposed regulations would extend the definition of limited partner to include certain interest holders in any entity that is classified as a partnership for federal income tax purposes.[122] As a result, unlike *Thompson* and *Gregg*, where the courts suggested that all LLC members are excluded from the scope of the passive activity presumption because LLCs are not state law limited partnerships,[123] not all LLC members would escape treatment as passive interests under the proposed regulations. Instead, an LLC member who does not have rights to manage the entity or the power to bind the entity under state law and under the LLC agreement will be treated as a limited partner for purposes of the passive activity presumption if the LLC is taxed as a partnership for Federal income tax purposes.[124] Conversely, under the proposed regulations' definition of limited partner, some partnership interests in state law limited partnerships would also be exempt from the passive activity presumption.[125]

III. Membership Interests Are Not Interests Held by Limited Partners

In determining whether the passive activity presumption applies to an LLC member, the critical inquiry is whether the LLC member holds his membership interest as a general partner or a limited partner.[126] The recent decisions and proposed regulations correctly conclude that not all LLC members hold their interests as limited partners.

Specifically, the courts in the recent cases have correctly held that LLC members, who have a right to manage the entity, are more similar to general partners than limited partners because the distinguishing characteristic is whether an investor may participate in the management of the business.[127] Thus, even though an LLC interest should constitute a limited partnership interest under the current regulations, an LLC member should be able to avoid the passive activity presumption through application of the general

[122] *See* Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).
[123] *See supra* notes 54, 81.
[124] *See* Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).
[125] *See id.*
[126] *See, e.g.*, Garnett v. Commissioner, 132 T.C. 368, 380–82 (2009).
[127] *Id.*

partner exception.[128] Under the general partner exception, an interest shall not be treated as a limited partnership interest if the interest holder is a general partner in the entity.[129]

Similarly, the proposed passive activity loss regulations also recognize that the boundary line between limited partners and general partners should be based on whether the interest holder has the right to manage the entity. Therefore, the proposed regulations would change the definition of limited partner to exclude interest holders who have rights to manage the entity.[130] These interest holders would not be subject to the limited partner tests for material participation.

Because many LLC members are more similar to general partners than limited partners, all LLC members should not automatically be subject to the passive activity presumption. As discussed below, excluding interest holders who have a right to manage the entity from the scope of the passive activity presumption is consistent with the statutory framework of the passive activity loss rules, a practical interpretation of the passive activity loss rules, and the legislative intent with respect to the passive activity loss rules.

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[128] This is the same conclusion reached by the Tax Court in *Garnett*. *See supra* note 73.

The legislative history of the passive activity loss rules and the plain meaning of the corresponding Treasury regulations indicate that an LLC interest may constitute a limited partnership interest. The legislative history suggests that Congress contemplated that the Secretary of the Treasury would have regulatory authority to treat "substantially equivalent entities" as limited partnerships for purposes of section 469. S. REP. No. 99-313, at 732 (1986) (noting that Congress intended that the exercise of this authority would generally occur in the context of providing that limited partnership interests in certain circumstances will not be treated as interests in passive activity); *see also* Garnett v. Commissioner, 132 T.C. 368, 380–82 (2009) (citing S. REP. No. 99-313, at 713–746 (1986)). Because an LLC is substantially similar to a limited partnership in several significant respects—including the existence of limited liability and the option to be taxed as a partnership for federal income tax purposes—an LLC should be treated as a limited partnership.

In addition, the corresponding temporary regulations explicitly state that a limited partnership interest exists if the investor's "liability for partnership obligations 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)." Temp. Reg. § 1.469-5T(e)(3)(i). Because the LLC laws of most states generally limit the obligations of LLC members to the sum of the member's capital contributions to the LLC and any contractual obligations to make additional capital contributions, a membership interest in an LLC should constitute a limited partnership interest under the plain meaning of the Treasury regulations. *See, e.g.*, ALA. CODE § 10A-5-3.02 (2008); HAW. REV. STAT. ANN. § 428-101 (LexisNexis 2006); IDAHO CODE ANN. § 30-6-101 (West 2006); 805 ILL. COMP. STAT. ANN. 180/1-1 (West 2006); IOWA CODE ANN. §§ 488.101-488.1207 (West 2009); MONT. CODE. ANN. § 35-8-111 (West 2006); S.C. CODE ANN. § 33-44-101 (1996); S.D. CODIFIED LAWS § 47-34A-401 (1996); TEX. BUS. ORGS. CODE. ANN. § 101.114 (West 2006); VT. STAT. ANN. tit. 11, § 3042 (1998); V.I. CODE. ANN. tit. 13, § 1101 2010; W. VA. CODE § 31B-3-303 (2011).

[129] Temp. Reg. § 1.469-5T(e)(3)(ii).

[130] Prop. Reg. § 1.469-5(e)(3), 76 Fed. Reg. 72,875 (2011).

A. *Statutory Framework*

As suggested by the statutory framework of the passive activity loss rules under the current regulations, an LLC interest should fall within the general partner exception to the passive activity presumption. Under the literal terms of the current regulations, the general partner exception clearly applies to situations where a partner in a state law limited partnership possesses dual limited and general partnership interests.[131] Although the current regulations do not extend the general partner exception to other situations, they also do not expressly confine the exception solely to these situations.[132]

This lack of statutory guidance on the application of the general partner exception to LLC interests should not automatically exclude such interests from the exception.[133] Many instances exist where a particular statute omits a reference to LLCs, but LLCs are nevertheless treated in the same manner as the referenced entity on the basis of other grounds—such as legislative intent or the purpose of the statute.[134] Thus, the absence of any reference to a general partner in numerous states' LLC statutes should not, in itself, be sufficient grounds to prevent LLC members from being treated like general partners of limited partnerships.[135]

Instead, an LLC member should qualify for the general partner exception. Treating an LLC member as a general partner for purposes of the gen-

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[131] Temp. Reg. § 1.469-5T(e)(3)(ii).

[132]

> 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).

See Temp. Reg. § 1.469-5T(e)(3)(ii).

[133] As noted earlier, neither the Code nor the Treasury regulations define "limited partner" or "general partner" for purposes of the passive activity loss rules. Moreover, the state laws governing the formation of LLCs do not generally identify the holders of LLC interests as either general or limited partners, but as "members."

[134] BISHOP & KLEINBERGER, *supra* note 36, at ¶ 1.03[1][a]("It is unwise to assume that LLCs fall outside a regulatory provision simply because the plain language of the provision refers to specific entity types and does not mention LLCs."); *see, e.g.*, Hartford Fire Ins. Co. v. United Restoration, LLC, No. CV020813517, 2003 WL 1962864, at *3–4 (Conn. Super. Ct. Apr. 4, 2003) (applying to an LLC a long-arm jurisdiction statute that refers only to foreign corporations).

[135] Likewise, a literal interpretation of the term "limited partner"—under which only a limited partner in an entity classified as a limited partnership under state law constitutes a limited partner for purposes of section 469—should also be rejected as inconsistent with legislative intent, as the Tax Court in *Garnett* has already done. *See* Garnett v. Commissioner, 132 T.C. 368, 377 (2009) (holding that such a narrow construction of the term "limited partner" is inappropriate, because although not free from doubt, the legislative history suggests that Congress has authority to treat substantially equivalent entities as limited partnerships and Congress contemplated that at least some ownership interests in substantially equivalent entities would be treated as interests held by limited partners).

eral partner exception is consistent with the purpose of that exception. The general partner exception seeks to exempt persons who are involved in the management of an entity from the limited partner presumption.[136] Because LLC members may perform management functions comparable to those of general partners—who clearly fall within the exception—the general partner exception should also apply to LLC members.

B. *Practical Interpretation*

Despite the lack of definitions and guidance in the Code and corresponding current Treasury regulations, a practical interpretation of the relevant terminology also suggests that a member's interest in an LLC is more akin to a general partner's interest in a limited partnership than that of a limited partner's interest. On the other hand, whenever members have management rights in the entity, this practical interpretation of the statute also supports certain LLC members, who completely lack management rights in the LLC, as limited partners for purposes of the passive activity loss rules, which is the approach suggested by the proposed passive activity loss regulations.[137]

Even though both LLCs and limited partnerships generally are treated as partnerships for federal income tax purposes, historically the two entities have differed significantly for state law purposes. For instance, two classes of interests comprise a limited partnership—limited partnership interests and general partnership interests. The general partners have management power as well as personal liability. Traditionally, the limited partners have been passive investors who "lack management powers and enjoy immunity from liability for debts of the partnership."[138] On the other hand, LLC members can both participate directly in management, like general partners, while maintaining their limited liability in the entity, like limited partners.[139]

The limited liability attribute enjoyed by both LLC members and limited partners is insufficient by itself to characterize an LLC interest as a limited partnership interest for purposes of the passive activity loss rules—the limited liability of LLC members is not the sole defining characteristic of an LLC. Instead, an LLC member's ability to participate in managing the entity *with-*

[136] *Garnett*, 132 T.C. at 378–80.

[137] *See supra* note 118.

[138] *Id.* at 375.

[139] *Id.* at 375–76. The state LLC statutes generally allow for the formation of a member-managed LLC, where each member has rights in the management and conduct of the LLC's business. Even if the LLC is manager-managed, a member may serve as a manager of the entity and may possess voting rights with respect to various management matters without losing its limited liability protections. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT (1996) § 404 (providing for the formation of a member-managed LLC where each member has equal rights in the management and conduct of the LLC's business and permitting members to have certain voting rights specified in the operating agreement with respect to various management matters); FLA. STAT. § 608.422 (2007); TAX. BUS. ORGS. CODE. ANN. § 101.251; DEL. CODE ANN. tit. 6, § 18-402 (2005).

out losing limited liability has been the key attraction of an LLC.[140]

This characteristic does not exist in a traditional limited partnership. If a state-law limited partner has any part in controlling the partnership, that limited partner is potentially exposed to personal liability.[141] Thus, from a practical perspective, a limited partner should not be defined by the limited liability afforded to a taxpayer as an LLC member. As held in *Garnett*, *Thompson*, and *Newell*, and as provided by the proposed regulations, a taxpayer's characterization as a general partner should depend on the degree of management the taxpayer exercises.[142]

C. *Legislative History*

The approach adopted by the recent decisions and proposed regulations is also consistent with the Congressional intent in respect to the passive activity presumption. The legislative history supports characterizing some LLC members as general partners for passive activity loss purposes.

According to the legislative history, the degree of management—rather than the lack of limited liability—is the defining characteristic of a general partner.[143] The Senate Report states that "in general, under relevant State laws, a limited partnership interest is characterized by limited liability *and* to maintain this status, a limited partner cannot be active in the partnership business."[144] Therefore, even though Congress considered limited liability to be one characteristic of a limited partner, it is not—as the Service persistently argued—the sole or determinative consideration.[145]

Furthermore, the statutory constraints historically imposed on a limited partner's ability to participate in a partnership's business are not applicable to LLC members. According to the legislative history, Congress enacted the passive activity presumption because the majority of the limited partnership statutes enacted at the time contained these statutory constraints on a limited partner's ability to participate in management.[146] Congress believed these statutory constraints on participation made it more certain that limited partners would not materially participate in the activity.[147] This certainty makes examining the general facts and circumstances regarding material participa-

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[140] *Garnett*, 132 T.C. at 375–76.

[141] *Id.*

[142] *See* Thompson v. United States, 87 Fed. Cl. 728, 735–36 (2009), *action on decision*, 2010-02 (Apr. 5, 2010); Newell v. Commissioner, 99 T.C.M. (CCH) 1107, 1111–12, 2010 T.C.M. (RIA) ¶ 10-023, at 158–59; *Garnett*, 132 T.C. at 379; Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

[143] *See Garnett*, 132 T.C. at 380.

[144] *Garnett*, 132 T.C. at 380; S. Rep. No. 99-313, at 731 (emphasis added).

[145] *See Garnett*, 132 T.C. at 380; S. Rep. No. 99-313, at 731.

[146] The Conference Report states that "[*b*]*ecause* a limited partner generally is precluded from materially participating in the partnership activities, losses and credits attributable to the limited partnership's activities are generally treated as from passive activities." H.R. Rep. No. 99-851, at 111 (1986) (Conf. Rep.) (emphasis added).

[147] *Garnett*, 132 T.C. at 380; S. Rep. No. 99-313, at 720.

tion unnecessary in this context.

But Congress's justification for the limited partner presumption does not extend to all membership interests in LLCs. As previously noted, state law generally does not prohibit LLC members, who enjoy limited liability, from actively participating in the company's management.[148] Thus, the basis of the presumption that certain ownership interests are intrinsically passive is not valid when interest holders have rights to participate in the entity's management. Because state law generally does not prohibit LLC members from activities involving participation in the LLC's management, LLC members should not be limited to the restrictive material participation tests that apply to limited partners if the LLC's operating agreement does not eliminate LLC members' management rights.

Instead, LLC members who have the freedom to participate in the management of an activity are more akin to general partner interests. An examination of the facts and circumstances is necessary to ascertain the nature and extent of these members' participation because not all LLC members participate in the same manner or amount.[149] As the Tax Court noted in *Garnett*, this determination is most appropriately made pursuant to the general tests for material participation, which is an already established facts-and-circumstances test.[150]

IV. Negative Implications of the Recent Decisions

The recent case holdings will often cause LLC members to fare better than limited partners in the passive activity loss context.[151] But these benefits come at a cost—especially when the LLC is profitable. As discussed below, the recent decisions may detrimentally affect (1) an LLC member's self-employment tax liability, (2) an LLC member's ability to deduct passive activity losses from other entities when the LLC is profitable, and (3) the economic efficiency of our income tax system.

A. *Self-Employment Tax of Members*

A potential downside of the recent decisions, which treat LLC members as general partners for passive activity loss purposes, is that they will likely increase an LLC member's self-employment tax liability when the LLC is profitable. The self-employment tax is a 15.3% tax on net earnings from self-employment.[152] This tax imposes an additional layer of tax on a taxpayer's earnings but excludes a limited partner's distributive share of partnership

[148] *See, e.g.*, CAL. CORP. CODE § 17150 (West 2011).

[149] *Garnett*, 132 T.C. at 221.

[150] *Id.*

[151] The newly issued proposed passive activity loss regulations would modify the definition of limited partner to exclude any interest holder with management rights, which is intended to treat limited partners in the same manner as LLC members. Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

[152] I.R.C. § 1401.

income from these taxable earnings.[153] As a result, the self-employment tax substantially impacts the tax liability of investors who are characterized as general partners for self-employment tax purposes.

1. *In General*

The self-employment tax is made up of two taxes—a 12.4% tax for Social Security—old-age, survivors, and disability insurance—and a 2.9% tax for Medicare—hospital insurance.[154] For the years 2011 and 2012, the self-employment tax is reduced to a 10.4% tax for Social Security and remains a 2.9% tax for Medicare.[155] A taxpayer's net self-employment income in an amount up to $110,100 for 2012 is subject to the entire self-employment tax—a tax rate of 13.3% in 2012.[156] Any net self-employment earnings above this amount are subject to only the 2.9% Medicare tax.[157] But beginning after December 31, 2012, the Medicare tax rate increases to 3.8% of self-employment wages in excess of $200,000 for taxpayers filing individually and $250,000 for joint filers.[158] In addition, after December 31, 2012, a new 3.8% Medicare tax will be imposed on "net investment income," which encompasses passive activity income.[159]

Net earnings from self-employment, which are subject to the self-employment tax, may include a taxpayer's distributive share of partnership—

[153] I.R.C. § 1401.

[154] I.R.C. § 1401(a), (b).

[155] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 601, 124 Stat. 3296, 3309, amended by Temporary Payroll Tax Cut Continuation Act of 2011, Pub. L. No. 112-78, § 101, 125 Stat. 1280, 1281.

[156] *Self-Employment Tax Rate*, Internal Revenue Service, http://www.irs.gov/businesses/small/article/0,,id=98846,00.html (last visited April 13, 2012). Prior to 2012, the wage base subject to the entire self-employment tax was $106,800. *Id.*

[157] *See id.*

[158] I.R.C. § 1401(b)(2), *amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411(b), 124 Stat. 1029, 1061 (2010), *amended by* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10906(b), 124 Stat. 119 (2010).

[159] I.R.C. § 1411, *amended by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411(a), 124 Stat. 1029, 1061 (2010), *amended by* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10906(b), 124 Stat. 119 (2010). The new 3.8% surtax is imposed on the lesser of the taxpayer's "net investment income" or the excess, if any, of the taxpayer's modified adjusted gross income for the taxable year over the $200,000—or $250,000 for joint filers—threshold amount. "Net investment income" includes typical investment items—such as interest, dividends, annuities, royalties, and rents—other than income which is derived in the ordinary course of a trade or business, as well as trade or business income derived from passive activities—within the meaning of section 469—and from trading in financial instruments and commodities and net gain attributable to the disposition of any property other than that held in an active, nonfinancial trade or business. Because the recent decisions make it easier for LLC members to avoid the passive activity characterization of their distributive share of LLC income, it is less likely that this new surtax will apply to such income of LLC members—unless an LLC member has a high modified adjusted gross income or a substantial amount of other net investment income.

including LLC—trade or business income.[160] Generally, a general partner's distributive share of the partnership income is subject to the self-employment tax—however, a limited partner's distributive share of the income is not.[161] Therefore, once again, an LLC member's status as general partner or limited partner significantly affects her tax liability. But—this time—limited partners fare better than general partners.

For instance, imagine that the attorney in the example above earned \$500,000 from her law practice this year. In addition, the attorney's art business, which is conducted through an LLC, becomes profitable. It generates approximately \$250,000 of additional income each year, which is allocated to the attorney. If the tax law treats the attorney as a general partner in the LLC for self-employment tax purposes, this additional income would be subject to the self-employment tax.

As a result, the income from the art business would be subject to the 2.9% Medicare tax prior to 2013.[162] Thereafter, the attorney's distributive share of the LLC income would likely be subject to a 3.8% tax because the attorney's law practice earnings place the attorney above the \$200,000 self-employment tax threshold. As a result, the attorney would pay an additional annual tax of \$7,250 until 2013, when her additional annual tax liability would increase to \$9,500. On the other hand, if the attorney were a limited partner—rather than a general partner—in the art business, the attorney would save \$7,250 in taxes in one year alone—provided that the payment made to the attorney is not a guaranteed payment for services under section 707(c).[163]

2. *Current Definitions of "Limited Partner" and "General Partner"*

It is unclear how the self-employment tax applies to an LLC member's distributive share of LLC income. Like the passive activity loss rules, the applicable statute does not define the term "limited partner" or the term "general partner," and the Service has had to issue guidance to address this statutory

[160] I.R.C. § 1402(a). The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less deductions attributable to such trade or business, plus his distributive share—whether or not distributed—of income or loss from any trade or business carried on by a partnership of which he is a member.

[161] I.R.C. § 1402(a)(13). However, a limited partner's guaranteed payments under I.R.C. § 707(c) in return for services are subject to the self-employment tax rules. In addition, other exceptions to the self-employment tax rules exist. *See* I.R.C. § 1402(a)(2), (3).

[162] The attorney would not be subject to the Social Security tax on his distributive share of the LLC income because the attorney's aggregate net earnings from self-employment for the year exceed \$110,100.

[163] *See* John R. Marquis, *Column: Business Problems & Planning: Current Status of Limited Liability Companies and the Self-Employment Income Tax*, 77 MICH. BAR J. 440 (1998) (illustrating that an individual must include her share of the partnership's earnings as net earnings from self-employment, which are subject to the self-employment tax, because of the individual's label as a general partner rather than because he or she actually participated in the partnership's business and "earned" her share).

omission.[164] Specifically, the Treasury Department has issued proposed self-employment tax regulations, which are intended to provide definitive rules on the self-employment tax's application to limited liability entities that differ from state law limited partnerships.[165]

The proposed self-employment tax regulations, issued in 1997, define when an investor constitutes a limited partner for self-employment tax purposes. These proposed regulations apply to all entities that constitute partnerships for federal income tax purposes, including general partnerships, limited partnerships, and limited liability companies—regardless of the state law characterization of the entity.[166] Accordingly, the same standards apply when determining the status of an investor in a state law limited partnership and the status of an investor in an LLC.

Under the proposed self-employment tax regulations, investors characterized as limited partners are less likely than investors characterized as general partners to have their partnership income subject to the self-employment tax. These proposed regulations treat investors in partnerships—including LLCs—as limited partners for self-employment tax purposes unless that investor possesses one of the following characteristics: (1) the investor has personal liability for debts of or claims against the partnership as a result of being a partner; (2) the investor has authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership; or (3) the investor participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.[167] An individual who provides services to a partnership that primarily involve the performance of health, law, engineering, architecture, accounting, actuarial science, or consulting services also cannot qualify as a limited partner under the proposed self-employment tax regulations.[168]

Therefore, limited partners of a limited partnership and LLC members of a manager-managed LLC could potentially avoid any self-employment tax liability on income attributable to the partnership or LLC, respectively, because they lack authority to contract on behalf of the entities. Pursuant to the proposed self-employment tax regulations, this income may only be subject to the self-employment tax if that partner or member participates in the entity's trade or business for more than 500 hours during the taxable year or provides services to a service partnership.[169]

Even when the above conditions are not satisfied, the proposed self-employment tax regulations treat an individual as a limited partner under certain

[164] *See* I.R.C. § 1402(a)(13); Prop. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (1997).

[165] Thomas J. Nichols, *Impact of New Tax Rates on Choice of Entity Issues*, THE NEWSLETTER OF THE COMMITTEE ON LLCS, PARTNERSHIPS AND UNINCORPORATED ENTITIES, Mar. 2010, *available at* http://apps.americanbar.org/buslaw/newsletter/0091/materials/pp6a.pdf.

[166] *See* Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997).

[167] Prop. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702 (1997).

[168] Prop. Reg. § 1.1402(a)-2(h)(5), 62 Fed. Reg. 1702 (1997).

[169] Prop. Reg. § 1.1402(a)-2(h)(5), 62 Fed. Reg. 1702 (1997).

circumstances.[170] For instance, investors with contracting authority who hold multiple classes of interests in the partnership may avoid the self-employment tax with respect to the interest held as a limited partner.[171] This means that an individual who is both a general and limited partner—or both a member and a manager—may come within this exception.

To qualify for this multiple class exception, the investor must satisfy two requirements immediately after acquiring his limited partnership interest. First, other investors who own a substantial, continuing interest in that same class of partnership interest must qualify as limited partners—that is, have no personal liability, contracting authority, or more than 500 hours of participation in the entity.[172] Second, the investor's rights and obligations with respect to that class of interest must be identical to the rights and obligations of the other investors who qualify as limited partners.[173] As a result, a manager, who is also a member, in a manager-managed LLC may qualify as a limited partner and avoid the self-employment tax on her distributive share of the LLC income attributable to that interest held as a limited partner.

3. *Effect of Recent Decisions and Proposed Passive Activity Loss Regulations*

Under the proposed self-employment tax regulations, most LLC members fall within the definition of "limited partner" and avoid any self-employment tax liability with respect to their distributive share of LLC income. As a result, many members of manager-managed LLCs may benefit from the best of both worlds from a tax perspective. Specifically, the proposed self-employment tax regulations—together with the case law on the passive activity loss rules—enable certain members to immediately deduct LLC losses as well as avoid the

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[170] Specifically, this may occur under two circumstances. First, an investor may be treated as a limited partner for self-employment tax purposes if (1) she participates in the partnership's business for more than 500 hours during the taxable year; (2) the sole reason the investor would not otherwise qualify for limited partner status must be that the investor's participation in the partnership's trade or business exceeded 500 hours during the partnership's taxable year—that is, the individual fails the third test; (3) immediately after the investor acquired that class of interest, nonparticipating limited partners must also own a substantial, continuing interest in that specific class of interest; and (4) the nonparticipating limited partners must also have identical rights and obligations with respect to the class of interest held by the investor. *See* Prop. Reg. § 1.1402(a)-2(h)(4), 62 Fed. Reg. 1702 (1997).

The second situation where the self-employment tax proposed regulations treat an individual as a limited partner even though she possesses one of the prohibited characteristics described above is when that individual holds multiple classes of interest. *See infra* notes 171–73 and accompanying text.

[171] *See* Prop. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (1997).

[172] Prop. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (1997). The determination of whether the other limited partners' interest in the entity constitutes a "substantial interest" under the proposed regulations is "determined based on all the relevant facts and circumstances," but in any event, 20% or more of that specific class is considered substantial. Prop. Reg. § 1.1402(a)-2(h)(6)(iv), 62 Fed. Reg. 1702 (1997).

[173] Prop. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (1997).

self-employment tax on their share of the LLC income.[174]

For instance, consider an LLC member who has no personal liability for LLC obligations or management authority in the LLC and who works in the LLC business more than 100 hours—but less than 500 hours—during the taxable year. According to *Thompson* and *Gregg*, that member may qualify as a general partner under the passive activity loss rules.[175] Thus, the member may deduct any losses attributable to the LLC immediately as nonpassive losses. Later, if that same LLC becomes profitable, the member would not be subject to any self-employment tax on her distributive share of LLC income pursuant to the proposed self-employment tax regulations—provided that the member continues to work less than 500 hours during the taxable year and the LLC is not a service partnership.[176]

On the other hand, a limited partner would not fare as well. If the investor in the example above were a limited partner in a limited partnership—instead of an LLC member—the investor would still not be subject to self-employment tax on her distributive share of the partnership's income under the proposed regulations.[177] But—unlike an LLC member—as a limited partner, the investor would not be able to immediately deduct any losses attributable to the partnership as nonpassive losses under the recent case law. Instead, the investor's ability to deduct such losses would be limited under the passive activity loss rules.[178]

This ability of investors to inconsistently apply and benefit from the definition of "limited partner" comes at the expense of the Treasury Department. The Service—aware of the detrimental effects of the recent case law—issued the proposed passive activity loss regulations to help mitigate this dichotomy.

Specifically, as discussed above, the proposed passive activity loss regulations would treat LLC members as limited partners for purposes of the passive activity loss rules if the member does not have rights to manage the entity

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[174] *See* Thompson v. United States, 87 Fed. Cl. 728 (2009); Newell v. Commissioner, 99 T.C.M. (CCH) 1107, 2010 T.C.M. (RIA) ¶ 10,023; Garnett v. Commissioner, 132 T.C. 368 (2009); Hegarty v. Commissioner, No. 3730-07S, T.C. Summ. Op. 2009-153, 2009 WL 3188789 (T.C. Oct. 6, 2009); Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997).

[175] *See supra* notes 55, 83.

[176] Similarly, a manager-member of an LLC may also qualify for such treatment if (1) the manager also holds a membership interest in the company; (2) immediately after the manager acquires that class of membership interest, nonmanager members, who have no personal liability, contracting authority or 500 hours of participation, own a substantial, continuing interest in that specific class of interest; and (3) the nonmanager members have identical rights and obligations with respect to that class of interest. Prop. Reg. § 1.1402(a)-2(h)(4), 62 Fed. Reg. 1702 (1997).

[177] I.R.C. § 1402(a)(13).

[178] This conclusion is based on the assumption that the taxpayer did not materially participate as a limited partner in any of the previous taxable years and therefore cannot overcome the passive activity presumption. Temp. Reg. § 1.469-5T(a)(4), (c).

under state law and under the governing agreement.[179] Therefore, under the proposed passive activity loss regulations and the proposed self-employment tax regulations, an LLC member with no management authority is more likely to be treated as a limited partner for purposes of both the passive activity loss rules and the self-employment tax rules.[180] Even if the proposed passive activity loss regulations do not apply, the Service has a strong incentive to challenge LLC members' characterizations for self-employment tax purposes.[181]

Given the holdings in *Garnett*, *Thompson*, *Hegarty*, and *Newell*—together with the Service's acquiescence in *Thompson*—an LLC member who is characterized as a general partner for purposes of the passive activity loss rules may find it difficult to claim that she constitutes a limited partner for self-employment tax purposes if challenged by the Service.[182] As discussed above, the courts generally agree that an LLC member is more akin to a general partner than a limited partner for passive activity loss purposes because a member may participate in the management of the entity.[183] Because the self-employment tax rules—like the passive activity loss rules—also seek to differentiate between actively earned income and investment income for taxation purposes, this reasoning easily may extend to the self-employment tax context.[184] Therefore, when confronted with the issue, the courts likely may conclude that a general partner for purposes of the self-employment tax rules should be defined in the same manner as a general partner for purposes of the passive activity loss rules.

Moreover, even though the currently proposed self-employment tax regulations define limited partner for self-employment tax purposes,[185] a court

[179] *See supra* notes 117–19 and accompanying text.

[180] Despite the foregoing, LLC members may still benefit from this inconsistent treatment. It has been recognized that the proposed passive activity loss regulations could be determined as stating that an interest holder is a general partner if either the interest holder has management rights under the local law or under the partnership agreement. Under this reading of the proposed regulations, a member of a member-managed LLC with no management authority under the operating agreement could potentially be treated as a general partner for purposes of the passive activity loss rules and therefore benefit from the circumstances described above. The Service may clarify the proposed passive activity loss regulations to preclude this result. Amy S. Elliott, *IRS May Clarify Limited Partner Interest Test in Material Participation Regs*, 2012 TAX NOTES TODAY 7-1 (Jan. 11, 2012).

[181] This only becomes an issue once the business has earnings. *See supra* Part IV.A.

[182] *See* Baker & Hostetler LLP, *Hurdle Lowered for LLC/LLP Members to Avoid Passive Activity Loss Rules*, LEXOLOGY (Aug. 4, 2009), http://www.lexology.com/library/detail.aspx?g=fa1527e4-43e5-4486-ab51-ae51407c18ce (last visited Dec. 26, 2011).

[183] *See supra* Part II.

[184] *See* Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011) (stating that the legislative history of section 1402 of the Code reveals that the intent of section 1402(a)(13) of the Code was to ensure that individuals who merely invested in an entity and who were not actively participating in the entity's business operations would not receive credits toward Social Security coverage); H.R. REP. No. 95-702, pt. 1, at 9 (1997) (providing that Congress intended to exclude for Social Security purposes certain earnings "which are basically of an investment nature").

[185] *See* Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997).

may disregard that definition in certain circumstances. Proposed regulations are not effective until finalized.[186] Therefore, despite the proposed self-employment tax regulations' arguably reasonable interpretation of the intent of section 1402(a)(13), which may be relied upon for certain purposes, the proposed self-employment tax regulations are not binding authority on courts.[187] The proposed self-employment tax regulations also have a "somewhat checkered past," which may further reduce their likely application.[188]

In fact, in a recent self-employment tax case, the Tax Court did not rely on the self-employment tax proposed regulations in concluding that investors in an LLP did not constitute limited partners for self-employment tax purposes.[189] Instead, in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, the Tax Court adopted a "participation test" to determine whether the owner was a limited partner who qualified for the limited partner exclusion from the self-employment tax.[190] Pursuant to this approach, it may be more difficult

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[186] Prop. Reg. § 1.1402(a), 62 Fed. Reg. 1702 (1997).

[187] Generally, taxpayers may rely on proposed regulations for certain purposes. For instance, whether the taxpayer's position is "supported by substantial authority" is relevant in defending a claim that the taxpayer understated her income tax. Treasury Regulation section 1.6662-4(d)(3)(iii) provides that "for purposes of determining whether there is substantial authority for the tax treatment of an item," the taxpayer is entitled to rely on "proposed, temporary and final regulations." In addition, in June 2003, a passive activity loss specialist at the Service stated that the Service will not challenge a taxpayer's self-employment tax treatment if the taxpayer conforms to the 1997 proposed regulations. More recently, a Service special counsel on Passthroughs and Special Industries affirmed that the Service would not challenge taxpayers who are "within the four corners" of the proposed regulations and took an otherwise reasonable position. Amy S. Elliott, *IRS Official Addresses Limited Partner Employment Tax Regs*, 126 TAX NOTES (TA) 301 (Jan. 18, 2010); *see* Nichols, *supra* note 165, at 26 (citing Business Entities, *IRS to Follow 1997 Proposed Regs in Applying Self Employment Tax Rules to LLC Members*, 5 No. 5 BUS. ENTITIES 48 (2003); Federal Tax Day, *Recent LLC Losses Regarding "Material Participation" Have IRS Rethinking Position*, CCH (Jan. 15, 2010)).

[188] *See* Nichols, *supra* note 165, at 24–26 (describing the legislative history of the proposed regulations, including the application of the self-employment tax to limited partners).

The Service previously issued proposed regulations in 1994 attempting to define "limited partner" for purposes of the limited partner exception to the self-employment tax but received mixed reactions from commentators. Preamble to Prop. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702, 1702 (1997). In 1997 the Service withdrew the original proposed regulations and issued the current 1997 proposed regulations, which were also heavily criticized for increasing the tax burden on small businesses and violating certain procedural requirements. Preamble to Prop. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702, 1702–03 (1997); Nichols, *supra* note 165, at 26. As a result, Congress imposed a moratorium preventing the Service from issuing final or proposed regulations that define a limited partner for purposes of the self-employment tax, which expired on July 1, 1998. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935 (elapsed 1998). Since the moratorium expired, Congress has not enacted new legislation with respect to this matter, and the Service has never withdrawn the 1997 proposed regulations nor promulgated any replacement. Nichols, *supra* note 165, at 26.

[189] Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011).

[190] *Renkemeyer*, 136 T.C. at 150 (focusing on whether the interest holder was actively participating in the business and whether the income received by that owner was in the nature of investment income in determining whether the interest holder was a limited partner for self-employment tax purposes).

for investors who constitute general partners for passive activity loss purposes to argue they are limited partners for self-employment tax purposes.

B. *Limited Deductibility of Other Passive Losses*

The recent decisions and proposed passive activity loss regulations are also detrimental to members of profitable LLCs who generate passive losses from other investments. As discussed above, the case law increases the likelihood that LLC members will satisfy the material participation threshold for deducting LLC losses.[191] Thus, when an LLC generates losses, LLC members benefit from the loss deduction. Such losses are more likely to be characterized as nonpassive losses, which offset income from nonpassive activities and portfolio investments.

On the other hand, when the LLC begins to generate income, this benefit is no longer helpful to active LLC members. This income likely constitutes nonpassive income, which cannot absorb passive losses from a member's other activities.[192] The passive losses generated by an investor's other investments remain useless until the investor generates sufficient passive income from other sources or disposes of the investment.[193]

Prior to these case holdings and proposed passive activity loss regulations, LLC members had a greater chance of successfully arguing that a profitable LLC investment was a passive activity which generated passive income. Thus, LLC members could take full advantage of the passive losses generated by their other passive activities by creating passive income that was available to offset passive losses. Given the recent decisions, this argument will likely not succeed. Once Service guidance is finalized, this avenue will be completely cut off to LLC members.

C. *Economic Inefficiency*

Another negative implication of the recent decisions addressing the passive activity loss rules' application to LLCs is that the decisions detrimentally affect the income tax system's economic efficiency. By substantially increasing the tax system's influence on taxpayers' business and investment activities, the recent case law exacerbates the economic inefficiencies in our tax system.

As several commentators have noted, the passive activity loss rules, in general, are inconsistent with the fundamental tax policy principles of equity, efficiency, and simplicity.[194] The passive activity rules currently distort economic behavior in a manner that results in a less efficient use of taxpayers' time and effort.[195] The recent case law developments in the passive activity loss context further contribute to this inefficiency by discouraging taxpayers

[191] *See supra* Part II.B.2.

[192] I.R.C. § 469(a), (d); Temp. Reg. §§ 1.469-1T(a), -2T(b), -3T(a).

[193] *See supra* note 17 and accompanying text.

[194] Peroni, *supra* note 12, at 3–6 (providing a complete critique of the section 469 passive loss rules).

[195] *See id.* at 86–87.

from shifting capital from unproductive tax shelters to investments motivated by economic profit.[196]

As a result of the recent decisions, investors who receive the same income and losses from identical activities may be subject to different tax consequences under section 469. These differences often depend on whether the investor participates in the activity through a limited partnership or through an LLC—or LLP or S corporation.[197] For instance, because of the lower material participation threshold for LLC members under the recent decisions, an investor may more easily deduct losses attributable to LLC activities than losses attributable to partnership activities. By treating investors in limited partnerships and LLCs inconsistently in this manner, the tax system further influences taxpayers' economic decision-making.[198]

Taxpayers now have a strong incentive to shift loss-producing passive investments to LLCs. Losses generated by an LLC are now more likely to be nonpassive losses under recent case law because LLC members—no longer facing the stringent passive activity presumption—can more easily satisfy the material participation standard. Therefore, the LLC losses may offset the investor's active income and portfolio investment income.

On the other hand, taxpayers may have an incentive to use the limited partnership form of business for investments that are expected to generate profits. Income generated by a limited partnership frequently constitutes passive income. Because passive income is available to absorb passive losses from other sources, characterizing the partnership income as passive income will help maximize a taxpayer's available deductions.[199]

As previously discussed, Congress enacted the passive activity loss rules to thwart investors from deducting passive losses attributable to tax shelter investments against nonpassive income. The recent decisions merely change the identity of the tax shelter participants from investors in limited partnerships to investors in LLCs. The recent decisions further distort the choice of

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[196] Instead of eliminating tax shelters, the passive activity loss rules distort economic behavior in a manner that influences the choice of business entity. The rules also encourage taxpayers to modify the amount of time in which they participate in different business activities based on whether the activity produces income or losses. For instance, section 469 encourages taxpayers to decrease their level of participation in activities that are generally profitable so that resulting income is treated as passive income, which is available to offset other passive losses. Conversely, taxpayers have an incentive to increase their participation in businesses that generate losses so that resulting losses are not characterized as passive losses and are available for immediate deduction. *See id.* at 86–87, 89.

[197] *See id.* at 89–91 (stating that taxpayers will be encouraged to choose general partnerships and S corporations rather than limited partnerships for loss-producing passive investments and to choose limited partnerships in the case where a passive investment will produce income of a nonportfolio nature).

[198] *See id.* at 90–91.

[199] *See id.* at 86, 90–91.

business organization used when taxpayers conduct an economic activity.[200]

A tax provision promotes efficiency by reducing the tax differences between the various choices of business form.[201] As one commentator notes, under an ideal income tax system, all forms of conducting business and raising capital would be treated equally so that a taxpayer would not choose a less efficient organizational form for tax reasons.[202] As the same commentator notes, "Section 469 already fails miserably on this score."[203] These new decisions only further perpetuate the problem.

The Treasury Department's issuance of the proposed passive activity loss regulations is a step in the right direction. Although the proposed regulations may need to be revised further, the proposed regulations extend the courts' definition of general partner to include limited partners of state law limited partnerships, which brings LLC members and limited partners more into parity for purposes of the passive activity loss rules. By treating LLC members and state-law limited partners similarly, the proposed passive activity loss regulations should improve the economic efficiency of our tax system.

V. Proposal for Reform

Based on the significant distortions in economic behavior caused by the passive activity loss rules and the self-employment tax rules, I suggest a broad proposal to remedy the situation. Namely, limited partners and general partners should be treated uniformly for tax purposes.

The revised limited partnership statutes enacted in most states and the creation and proliferation of LLCs, LLPs, and limited liability limited partnerships (LLLPs) have considerably narrowed and—many times—have eliminated the traditional distinctions between general partners and limited partners.[204] As a result, these changes have substantially blurred the boundary line between investors labeled as limited partners and investors labeled as general partners.

In addition, Congress's rationale for distinguishing between general partners and limited partners for passive activity loss and self-employment tax purposes

[200] Prior to these recent decisions, section 469 had already distorted the choice of business entity by encouraging a taxpayer to select a certain business form depending on whether the business was anticipated to generate profits or losses and depending on the industry of the business. *See id.* at 89–94.

[201] *Id.* at 89.

[202] *Id.*

[203] *Id.*

[204] *See, e.g.*, UNIF. LTD. P'SHIP ACT § 303 (2001) (removing the statutory constraints on a limited partner's freedom to participate in management of an entity).

no longer exists.[205] Without this rationale, the distinction between general partner and limited partner no longer serves a valid purpose. Eliminating the need to label an investor as a limited partner or general partner for tax purposes should simplify an investor's choice of entity decision and improve the economic efficiency and administrative simplicity of our tax system.[206]

According to the legislative history, Congress enacted section 469(h)(2) because the majority of the limited partnership statutes enacted at such time imposed statutory constraints on a limited partner's ability to participate in the partnership business.[207] But since then, many states have revised their partnership statutes to permit limited partners to materially participate in the partnership business without losing limited liability protection. For instance, the Uniform Limited Partnership Act of 2001 has removed the statutory constraints on a limited partner's freedom to participate in the management of

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[205] *See* Prop. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (1997) ("[In the past], state laws generally did not allow limited partners to practice in the partnership's trade or business to the extent that state laws allow limited partners to participate today. Thus, even in the case of a state law limited partnership, a functional approach is necessary to ensure that the self-employment tax consequences to similarly situated taxpayers do not differ depending upon where the partnership organized.").

[206] The "check-the-box" regulations, which were finalized in 1997, were enacted for a similar purpose. The "check-the-box" regulations simplified the system previously used to classify an unincorporated business entity as a partnership or a corporation for tax purposes. The regulations eliminated the need to determine whether an entity had a preponderance of four specified factors, which would make it a corporation. This four-factor test was abolished after the Service recognized that even though the entity classification rules were based on the historical differences under local law between partnerships and corporations, many states had revised their statutes to provide that unincorporated organizations—for example, LLCs and LLPs—could possess characteristics that traditionally had been associated with corporations. Thus, taxpayers could structure the entity to achieve the tax classification they desired, which essentially makes the entity classification elective. *See* Simplification of Entity Classification Rules, 61 Fed. Reg. 66584-85, 66587 (Dec. 18, 1996) (promulgated as Reg. §§ 301.7701-1 to -3); Notice 1995-14, 1995-1 C.B. 297.

[207] The "control rule," which was a part of the majority of limited partnership statutes in force at the time the passive activity loss rules were enacted, generally precluded a limited partner who wanted to maintain limited liability status from materially participating in the business activity of the partnership. *See* S. Rep. No. 99-313, at 718 (1986).

an entity.[208] Similarly, the Revised Uniform Limited Partnership Act permits limited partners to engage in numerous safe harbor activities, which effectively enables limited partners to participate in the management of the partnership.[209] Thus, it is no longer accurate to presume that a limited partner will not be involved in the management of an entity.

Instead of presuming a lack of limited partner involvement in the entity's management, as with general partners, a facts-and-circumstances analysis should be used to determine the partner's participation in the management of an entity. This facts-and-circumstances analysis should apply uniformly to all investors. Therefore, if the Treasury Department wishes to impose a more stringent material participation standard on LLC members, the Department should revise the material participation test that is currently set forth in the temporary regulations, rather than merely change the definition of limited partner to extend the limited partner presumption to certain LLC members.

Moreover, even without taking into account these statutory revisions of the states' limited partnership statutes, investors who desire to both participate in the management of an entity and maintain limited liability status may do

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[208]The Uniform Limited Partnership Act of 2001, which at this time has been enacted by fifteen states, explicitly states that "a limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership." UNIF. LTD. P'SHIP ACT § 303 (2001). The states that have adopted the Uniform Limited Partnership Act (2001) are Alabama, Arkansas, California, Florida, Hawaii, Idaho, Illinois, Iowa, Kentucky, Maine, Minnesota, Nevada, New Mexico, North Dakota, and Washington. ALA. CODE §§ 10A-9-1.01 to -12.08 (LexisNexis 2010); ARK. CODE. ANN. §§ 4-47-101 to -1302 (2001); CAL. CORP. CODE §§ 15900–15912.07 (Deering 2009); FLA. STAT. ANN. §§ 620.1101–.2205 (West 2007); HAW. REV. STAT. ANN. §§ 425E-101 to -1206 (LexisNexis 2008); IDAHO CODE ANN. §§ 53-2-101 to -1205 (2009); 805 ILL. COMP. STAT. 215/0.01 to /1402 (2011); IOWA CODE ANN. §§ 488.101–.1207 (West 2009); KY. REV. STAT. ANN. §§ 362.2-102 to -1207 (LexisNexis 2008); ME. REV. STATE. ANN. tit. 31, §§ 1301-1461 (2010); MINN STAT. ANN. §§ 321.0101–.1208 (West 2011); NEV. REV. STAT. §§ 87A.010–.700 (2011); N.M. STAT. ANN. §§ 54-2A-101 to -1206 (2009); N.D. CENT. CODE. 45-10.2-01 to -117 (2007); WASH. REV. CODE 25.10.006–.926 (2010).

[209]The Revised Uniform Limited Partnership Act is currently in force in most states that have not enacted the Uniform Limited Partnership Act. Even though the Revised Uniform Limited Partnership Act does not explicitly eliminate the control rule, it greatly minimizes the probability that a limited partner will be classified as a general partner merely by participating in the partnership's business. The lengthy list of safe harbor activities set forth in the Revised Uniform Limited Partnership are deemed activities that do not constitute participating in control. These safe harbor activities effectively limit "control rule" liability "only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." UNIF. LTD. P'SHIP ACT § 303 cmt. (2001) (citing REVISED UNIF. LTD. P'SHIP ACT (1985)).

so by conducting a business or activity through an LLC, LLP, or LLLP.[210] Investors in these types of entities possess characteristics traditionally associated with general partners as well as characteristics associated with limited partners.

But despite these shared limited partner characteristics, the recent case law treats investors in LLCs and LLPs as general partners for purposes of the passive activity loss rules.[211] Therefore, pursuant to these decisions, using an LLC, LLP, or LLLP enables investors to easily avoid limited partner status and overcome the passive activity presumption.

Because investors can easily avoid limited partner status by using these alternative forms of business, the passive activity presumption has effectively become an elective presumption. Accordingly, retaining the passive activity presumption in a world with LLPs, LLCs, and LLLPs makes little sense. Instead, by abolishing the passive activity presumption, Congress can eliminate the existing dichotomy between limited partners and general partners in the passive activity loss context. The proposed passive activity loss regulations helps minimize this effect by modifying the definition of limited partner to include some LLC members and LLP partners and to exclude some state-law limited partners.[212] However, completely eliminating the passive activity presumption would further improve the economic efficiency of our tax system by simplifying a taxpayer's choice of entity decision and the administration of the tax law.

Similarly, if Congress rewrites section 1402 to treat limited partners and general partners consistently for self-employment tax purposes, Congress can further decrease the tax system's influence on a taxpayer's choice of business organization. Because limited partners can now participate in a partnership's business, the historical reason for differentiating between limited partners and general partners no longer exists for self-employment tax purposes, and the distinction between limited partners and general partners no longer serves a valid purpose.

According to the legislative history, Congress enacted the limited partner exception to self-employment taxes because a limited partner does not participate to any significant degree in the management of the partnership.[213] As with the passive activity loss rules, Congress enacted the limited partner

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[210]The drafters of the Uniform Limited Partnership Act found it necessary to eliminate the "control rule" because "[i]n a world with LLPs, LLCs, and, most importantly, [LLLPs], the control rule has become an anachronism." UNIF. LTD. P'SHIP ACT § 303 cmt. (2001). Eliminating the "control rule" with respect to limited liability for partnership obligations made sense in that it brought limited partners into parity with LLC members, LLP partners, and corporate shareholders.

[211]*See, e.g.*, Gregg v. United States, 186 F. Supp. 2d 1123, 1129 (D. Or. 2000).

[212]*See* Prop. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (2011).

[213]*See* Preamble to Prop. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702, 1703 (1997); Marquis, *supra* note 163 (stating that section 1402(a)(13) was enacted at a time when a limited partner was generally a passive investor in the partnership).

exception to the self-employment tax at a time when state laws generally did not allow limited partners to participate in the partnership's trade or business to the extent state laws permit limited partners to participate today.[214] Today, this fundamental assumption no longer applies. The revised partnership statutes allow limited partners to participate in the management of a partnership without losing limited liability protection.[215]

As a result, the limited partner exception to the self-employment tax frequently enables investors who actively participate in an activity—but are labeled as limited partners—to avoid the self-employment tax. This outcome is contrary to Congress's intent of imposing the self-employment tax on actively earned income.[216] By rewriting section 1402 to eliminate the need to differentiate between limited partners and general partners, Congress can remedy this situation. Specifically, Congress should not impose the self-employment tax on the basis of an arbitrary general partner label. Instead, Congress should ensure the self-employment tax's application depends on the degree of the investor's participation in the entity, as suggested by the Tax Court in *Renkemeyer*.[217]

The increasingly widespread use of the LLC, LLP, and LLLP form of business has also further increased the difficulty in distinguishing between a general partner and limited partner for self-employment tax purposes. Investors may use alternate business forms to manipulate the boundary line between general partners and limited partners to decrease their self-employment tax liability.

Even though the proposed regulations issued in 1997 adopt functional tests intended to ensure that the tax law treats similarly situated individuals who own interests in entities formed under different statutes or in different jurisdictions consistently,[218] these regulations have not been entirely successful. With a little planning, investors can select the label—either limited partner or general partner—that is most beneficial to that investor from a tax perspective. But if Congress were to treat limited partners and general partners uniformly for self-employment tax purposes, similarly situated investors are more likely to be treated consistently under the self-employment tax statute.

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[214] *See* Marquis, *supra* note 163, at 440 n.6 (noting that section 7 of the Uniform Limited Partnership Act provides that a limited partner is not liable for claims against the partnership unless she "takes part in the control of the business").

[215] *See, e.g.*, Unif. Ltd. P'ship Act § 303 (2001).

[216] *Cf.* Prop. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (1997) ("Together, these rules exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership.").

[217] Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137, 150 (2011)

[218] Prop. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (1997).

VI. Conclusion

The recent case law and proposed passive activity loss regulations finally provide some much needed guidance in an area that has affected many investors for decades—the application of the passive activity loss rules to limited liability companies. The courts in several cases and the proposed passive activity loss regulations correctly apply the passive activity loss rules to LLCs by treating LLC members, who have rights to manage the entity, in the same manner as general partners of limited partnerships. These court holdings, together with the Service acquiescence and the proposed passive activity loss regulations, have been accurately hailed as a significant taxpayer victory.[219] Many taxpayers investing in LLCs may now deduct LLC losses with confidence that the risk of a Service challenge is low.

Despite this generally pro-taxpayer result, the recent decisions also have negative implications for certain investors and for the economic efficiency of our tax system. Ultimately, Congress should rewrite section 469 and section 1402 so as to treat limited partners and general partners equally. Abolishing the distinction between general and limited partners should help deter tax shelters and increase the tax system's economic efficiency, equity, and simplicity. By eliminating the passive activity presumption and the limited partner exception to the self-employment tax, Congress can bring limited partners into parity with LLC members, LLLP partners, and corporate shareholders. As a result, the tax system's influence on a taxpayer's choice of business organization should decrease.

[219] *See, e.g.*, Rick Taylor, *Courts Reject IRS Unreasonableness on Passive Losses*, WIPFLI CPAs AND CONSULTANTS (July 28, 2009), http://www.wipfli.com/BlogPost_Blog_Tax_7_28_09.aspx (last visited Dec. 27, 2011) ("Following on the heels of *Garnett*, the Court of Federal Claims in a case of first impression issued a decisive taxpayer victory [in *Thompson*].").