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Issue Contents

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The Tax Court and the U.S. Court of Federal Claims Agree: Members of LLCs and LLPs Are Not to be Treated as Limited Partners

-by Neil E. Harl*

In a decision in late June, 2009, the United States Tax Court[1] held that ownership interests in a limited liability company (LLC) or limited liability partnership (LLP) should not be treated as limited partners in a limited partnership.[2] About a month later, the U.S. Court of Federal Claims decided a case[3] that went a notch beyond the holding in the earlier Tax Court case. That provides major support for the view that the statute which states ". . . [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"*[4] does not require members of LLCs and LLPs to be limited in how the material participation test[5] can be met.[6] That at least expands the opportunities to meet the material participation test to the seven tests that are ordinarily available to taxpayers[7] rather than the three tests specified in the temporary regulations for limited partners,[8] thus increasing the chances for meeting the required standard of material participation on a regular, continuous and substantial basis.[9] As noted below, the decision by the U.S. Court of Federal Claims goes a step further in favoring the taxpayer.

The regulatory framework

Losses from passive trade or business activities, to the extent deductions exceed passive activity income (exclusive of portfolio income), in general may not be claimed against other income, only against passive activity income.[10] An activity is considered to be a passive activity if the activity involves the conduct of a trade or business and the taxpayer does not materially participate in the activity.[11] A taxpayer is treated as materially participating in an activity only if the person ". . . is involved in the operations of the activity on a basis which is – (A) regular, (B) continuous, and (C) substantial."[12] LLCs and LLPs are not mentioned specifically in the statute[13] or the temporary regulations[14] inasmuch as in 1986, when the passive activity statute was enacted,[15] only two states (Wyoming, in 1977 and Florida in 1982) authorized entities denominated as limited liability companies and LLPs did not come into existence until the 1990s.

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As noted, the statute states that '. . . no interest as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."[16] The temporary regulations specify seven tests for material participation under the passive activity loss rules – (1) participation for more than 500 hours during the year,[17] (2) for situations requiring less than 500 hours of involvement, "substantially all" of the participation in the activity,[18] (3) more than 100 hours per year and the participation is not less than that of any other individual,[19] (4) the aggregate participation in "significant participation" activities exceeds 500 hours,[20] (5) material participation for five of the last ten taxable years in the activity,[21] (6) for personal service activities, any three preceding taxable years[22] and (7) material participation based on all of the facts and circumstances.[23] Farm taxpayers are permitted to qualify as materially participating if they participated materially for five or more years in the eight year period before retirement or disability.[24]

The temporary regulations hold limited partners to three tests for material participation – (1) more than 500 hours during the year,[25] (2) the limited partner materially participated in the activity for five or more of the ten preceding years[26] and (3) for personal service activities, any three preceding years.[27]

Position of LLCs and LLPs

In general, a partnership interest (and, for tax purposes, an LLC or LLP is considered a partnership) is treated as a limited partnership interest if so designated in the organizational documents or the liability of the holder of the interest is limited to a fixed, determinable amount under state law such as the amount contributed to the entity.[28] However, a *general* partner who holds an interest in a limited partnership is not necessarily treated as a limited partner.[29] As we noted in a 2008 article,[30] the temporary regulations would seem to indicate that, if the focus is on limited liability of the LLC member for obligations of the LLC, an LLC member would be treated as a limited partner. However, if the focus is on participation in management, the position of an LLC member is different in that a limited partner cannot be active in the partnership's business and if a limited partner becomes active in management, the limited partner may lose the feature of limited liability.[31]

The Congressional Committee Reports lend support to that interpretation.[32]

A case decided in 2000, *Gregg v. United States,*[33] recognized that LLCs are designed to permit members to engage in active management of the business without losing their limited liability feature which can occur with a limited partner. The court in *Gregg v. United States*[34] held that , inasmuch as the regulations did not state that members of an LLC were to be treated as limited partners, it was inappropriate to treat LLC members as limited partners.[35] The court made it clear that an LLC member could show material participation based on the seven tests in the temporary regulations[36] rather than the higher standard specified in the temporary regulations for limited partners.[37]

Garnett v. Commissioner

The 2009 Tax Court case of *Garnett v. Commissioner,*[38] citing *Gregg v. United States*,[39] involved taxpayers who owned seven limited liability partnerships and two limited liability companies in Iowa, all engaged in farming and agribusiness operations. The LLP agreements provided that each partner would actively participate in the control, management and direction of the LLP's business.[40] The LLC operating agreements provided that business was to be conducted by a manager.[41]

The Tax Court focused on the application of the "general partner exception" and believed the LLP and LLC members had the right to participate in management, as do general partners, which justified that exception inasmuch as state law did not preclude the members from actively participating in the management and operations of the LLPs and LLCs. Accordingly, the members were entitled to apply all seven of the tests for material participation and were not limited to the three prescribed for limited partners.[42]

The Internal Revenue Service had also treated two interests in tenancy in common as limited partnerships which the Tax Court rejected.[43]

Thompson v. United States

The decision of the U.S. Court of Federal Claims, *Thompson v. United States,*[44] cited approvingly both *Gregg v. United States*[45] and *Garnett v. Commissioner*[46] but went beyond those decisions in stating that the regulation[47] " . . . is simply inapplicable to membership interests in an LLC."[48] That suggests that the current I.R.C. § 469 does not limit the losses in question.

ENDNOTES

[1] Garnett v. Comm'r, 132 T.C. No. 19 (2009).

[2] I.R.C. § 469(h)(2). See generally 4 Harl, *Agricultural law* § 30.08[1] (Matthew Bender 2009); Harl, *Agricultural Law Manual* § 4.05[3][a] (Agricultural Law Press 2009); 2 Harl, *Farm Income Tax Manual* § 4.08 (Matthew Bender 2009). See also Harl, "Are Members of LLCs 'Limited Partners'?" 19 *Agric. L. Dig.* 109 (2008).

[3] Thompson v. United States, 2009-2 U.S. Tax Cas. (CCH) ¶. 50,500 (Fed. Cl. 2009).

[4] I.R.C. § 469(h)(2) (emphasis added).

[5] Temp. Treas. Reg. § 1.469-5T(a).

[6] Temp. Treas. Reg. § 1.469-5T(e)(2). See Temp. Treas. Reg. §§ 1.469-5T(a)(1), 1.469-5T(a)(5), 1.469-5T(a)(6).

[7] Temp. Treas. Reg. § 1.469-5T(a)(1) through (7).

[8] Temp. Treas. Reg. § 1.469-5T(e).

[9] I.R.C. § 469(h)(1).

[10] I.R.C. § 469(a)(1).

[11] I.R.C. § 469(c)(1).

[12] I.R.C. § 469(h)(1).

[13] I.R.C. § 469.

[14] Temp. Treas. Reg. § 1.469-5T.

[15] Pub. L. No. 99-514, § 501(a), 100 Stat. 2233 (1986), enacting

I.R.C. § 469.

[16] I.R.C. § 469(h)(2).

[17] Temp. Treas. Reg. § 1.469-5T(a)(1).

[18] Temp. Treas. Reg. § 1.469-5T(a)(2).

[19] Temp. Treas. Reg. § 1.469-5T(a)(3).

[20] Temp. Treas. Reg. § 1.469-5T(a)(4).

[21] Temp. Treas. Reg. § 1.469-5T(a)(5).

[22] Temp. Treas. Reg. § 1.469-5T(a)(6).

[23] Temp. Treas. Reg. § 1.469-5T(a)(7).

[24] Temp. Treas. Reg. § 1.469-5T(h)(2).

[25] Temp. Treas. Reg. § 1.469-5T(a)(1).

[26] Temp. Treas. Reg. § 1.469-5T(a)(5).

[27] Temp. Treas. Reg. § 1.469-5T(a)(6).

[28] Temp. Treas. Reg. § 1.469-5T(e)(3).

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

[30] Harl, "Are Members of LLCs 'Limited Partners'?" 19 *Agric. L. Dig.* 109 (2008).

[31] See 8 Harl, *Agricultural Law* § 61.01[3][a][i][A] (2009).

[32] See Conf. Report to H.R. 3838, Tax Reform Act of 1986; Joint Committee on Taxation, Staff Description (JCS-10-87), Tax Reform of 1986 ("Blue Book").

[33] 186 F. Supp. 2d 1123 (D. Or. 2000).

[34] *Id.*

[35] *Id.*

[36] Temp. Treas. Reg. § 1.469-5T(a)(1) through (a)(7).

[37] Temp. Treas. Reg. § 1.469-5T(e)(2).

[38] 132 T.C. No. 19 (2009).

[39] 186 F. Supp. 2d 1123 (D. Or. 2000).

[40] *Id.*

[41] *Id.*

[42] Temp. Treas. Reg. § 1.469-5T(e)(2).

[43] Garnett v. Comm'r, 132 T.C. No. 19 (2009).

[44] 2009-2 U.S. Tax Cas. (CCH) ¶. 50,500 (Fed. Cl. 2009).

[45] 186 F. Supp. 2d 1123 (D. Or. 2000).

[46] 132 T.C. No. 19 (2009).

[47] Temp. Treas. Reg. § 1.469-5T(e)(3).

[48] Thompson v. United States, 2009-2 U.S. Tax Cas. (CCH) ¶. 50,500 (Fed. Cl. 2009).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

ADVERSE POSSESSION

PRESCRIPTIVE EASEMENT. The plaintiff purchased a parcel of neighboring land from the defendant. The parties disagreed as to the northern boundary of the purchased land, with the defendant arguing that the border created a square parcel and the plaintiff arguing that the boundary was a fence. The plaintiff installed a septic system which had a leach field that extended onto the disputed land. The defendant instructed a tenant to farm the disputed land but the plaintiff told the tenant not to drive on the land because it would damage the leach field. The plaintiff stored machinery on the land at the alleged boundary but the defendant removed some of the machinery. The machinery left was too heavy to be moved. The plaintiff sought title to the disputed land by adverse possession over ten years. The court held that the actions of the defendant were sufficient to show that the plaintiff did not have exclusive use and possession of the disputed land; therefore, the plaintiff did not acquire title by adverse possession. The plaintiff also sought a prescriptive easement for the use of the leach field. The court held that the defendant had sufficient notice of the construction and existence of the leach field for over 10 years to create a prescriptive easement for the plaintiff. **Townsend v. Nickell, 2009 Iowa App. LEXIS 274 (Iowa Ct. App. 2009)**

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BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor, a citizen of Canada, had borrowed funds from a Canadian corporation in order to pursue a medical education. The debtor did not complete the education and declared bankruptcy in the U.S. The Canadian corporation sought to have the loan declared nondischargeable under Section 523(a)(8) as a qualified education loan, as defined in I.R.C. § 221(d)(1). The debtor argued that the loan was not a qualified education loan because the debtor was not a "taxpayer" inasmuch as the debtor never filed a U.S. income tax return. The court held that, although the debtor was potentially liable for U.S. taxes, the debtor, as a resident alien, was not a taxpayer until the debtor filed a return. Therefore, the loan was not nondischargeable as a qualified education loan. ***In re* LeBlanc, 2009-2 U.S. Tax Cas. (CCH) ¶ 50,498 (Bankr. M.D. Pa. 2009)**.

FEDERAL FARM PROGRAMS

CHICKEN. The FSIS has issued re-proposed regulations providing new information on, and re-proposing the definition and standard for, "roaster" and "roasting chicken." FSIS had proposed this definition and standard in its September 29, 2003, proposed rule to amend the definitions and standards for the official U.S.