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Proposed Regulations Recognize Uniqueness of LLCs and Other Passthrough Entities: Passive Loss Rules Relaxed

-by Neil E. Harl*

The decade-long battle to establish that members of limited liability companies, limited liability partnerships and other pass-through entities are not mirror images of limited partners in a limited partnership for passive activity loss purposes[1] reached a new level on November 28, 2011.[2] On that date, the Department of the Treasury issued proposed regulations agreeing that members of LLCs and LLPs should not be treated the same as limited partners for passive activity loss purposes.[3] That shift in authority is immensely important to members of LLCs and LLPs.

History of the controversy

The Internal Revenue Service (and the Department of the Treasury) started off the controversy in temporary regulations issued in 1988[4] by defining limited partnerships for passive activity loss purposes narrowly in allowing *only three of the seven tests for material participation on a "regular, continuous and substantial basis" to be used for limited partnerships*.[5] Those tests were – (1) where the limited partner participates for more than 500 hours;[6] (2) where the limited partner materially participated for five or more of the ten preceding years;[7] or (3) the activity is a personal service activity in which the limited partner materially participated for any three preceding years.[8] The other four tests were off-limits for limited partners.

Because of the way limited partnership interests were defined in the temporary regulations,[9] limited liability companies (LLCs) and limited liability partnerships (LLPs) were classified the same as limited partnerships. The temporary regulations defined "limited partnership interest" as an interest ". . . designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, regardless of whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law, or . . . the liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount. . . ."[10] Inasmuch as an LLC, for example, is a hybrid entity with the structural features of a corporation but the tax treatment of a partnership, the limited liability aspect of an LLC made the entity subject to the limited partnership rules.

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Reaction of the courts

The courts hearing cases challenging the IRS treatment of pass-through entities with limited liability uniformly rejected the classification of LLC members as limited partners. In *Gregg v. United States,*[11] the District Court held that, in the absence of a specific regulation for LLCs, it was inappropriate for IRS to treat LLC members as limited partners. Nearly a decade later, the Tax Court in *Garnett v. Commissioner,*[12] applied the "general partner" exception and allowed the LLC members to use any of the seven tests for material participation, not just the three prescribed for limited partners. The same year, 2009, in *Thompson v. United States,*[13] the court held that the regulation was ". . . .simply inapplicable to membership interests in an LLC." Similar sentiments were voiced in *Newell v. Commissioner*[14] and *Hegarty v. Commissioner.*[15]

At the 68th Institute on Federal Taxation at New York University on October 21, 2009, an IRS associate chief counsel stated that "[T]he issues in *Garnett* and *Thompson* . . . [are] legitimate and . . . IRS intends eventually to respond with guidance."[16] A year later, at the 69th Institute, the same associate chief counsel stated that ". . . a regulations project is underway that is designed to offer taxpayers the IRS's current thinking on the matter."[17]

The proposed regulations

So what direction did the Department of the Treasury take? On November 28, 2011, the Treasury announced proposed regulations essentially adopting the reasoning of the cases of *Gregg, Garnett, Thompson and Newell.*[18] The new regulations restrict the definition of "interest in a partnership" as a limited partner to situations in which the limited partner is in an entity in which the limited partnership interest is classified as a partnership for federal income tax purposes *and* the holder of the interest ". . . does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement."[19]

Therefore, LLCs in which the members have the right to participate in management are not to be deemed limited partnerships and the members are not to be treated as limited partners and are eligible to use all seven of the tests for determining material participation on a "regular, continuous and substantial basis," the same as other taxpayers who are not limited to the three which are available to limited partners. Of course, LLC members who are not allowed to participate in management would appear to be confined to the three tests available to limited partners.

Effective date

As to effective date, the proposed regulations state "the regulations are proposed to apply to taxable years beginning on or after the date of publication of the Treasury decision adopting these regulations as final regulations in the Federal Register."[20]

ENDNOTES

[1] I.R.C. § 469.

[2] Prop. Treas. Reg. § 1.469-5T(e). See Gregg v. United States, 186 F. Supp. 2d 1123 (D. Or. 2000); Garnett v. Comm'r, 132 T.C. 368 (2009); Thompson v. United States, 87 Fed. Cl. 728 (Fed. Cl. 2009); Newell v. Comm'r, T.C. Memo. 2010-23; Hegarty v. Comm'r, T.C. Summary Op. 2009-153. See generally 4 Harl, *Agricultural Law* § 30.08[1][a][iii][D] (2011); Harl, *Agricultural Law Manual* § 4.05[3][c][iv] (2011); 2 Harl, *Farm Income Tax Manual* § 4.08[2][h][ii] (2011 ed.); Harl, "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," 20 *Agric. L. Dig.* 113 (2009); Harl, "Forming and Managing an LLC," 22 *Agric. L. Dig.* 89 (2011).

[3] Temp. Treas. Reg. § 1.469-5T(e).

[4] T.D. 8175, corrected 3/29/96; amended by T.D. 8253, 5/11/89 and T.D. 8417, 5/12/92.

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

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

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

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

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

[10] Temp. Treas, Reg. § 1.469-5T(3)(i).

[11] 186 F. Supp. 2d 1123 (D. Or. 2000).

[12] 132 T.C. 368 (2009).

[13] 87 Fed. Cl. 728 (Fed. Cl. 2009).

[14] T.C. Memo. 2010-23.

[15] T.C. Summary Opinion 2009-153.

[16] CCH Federal Tax Day, October 22, 2009.

[17] CCH, October 20, 2010.

[18] Prop. Treas. Reg. § 1.469-5(e).

[19] Prop. Treas. Reg. § 1.469-5(e)(3)(i).

[20] REG-109369-10, November 28, 2011.

[24] See Treas. Reg. § 1.6662-4(d)(3)(iii).