May 4, 2012

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Issued Under Section 469

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations issued under section 469. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William M. Paul
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Michala Irons, Attorney, Internal Revenue Service
ABA SECTION OF TAXATION
COMMENTS ON PROPOSED REGULATIONS
ISSUED UNDER SECTION 469

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jeanne Sullivan of the Partnerships & LLCs Committee of the Section of Taxation. Substantive contributions were made by Paul Carman, Christopher McLoon, and Timothy J. Leska. The Comments were reviewed by Matthew Lay for the Partnerships & LLCs Committee, and by Bahar Schippel, Committee Chair. The Comments were further reviewed by Richard Lipton of the Section’s Committee on Government Submissions and by Eric Sloan, Council Director for the Partnerships and LLCs Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the Federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 4, 2012
EXECUTIVE SUMMARY

Section 469\(^1\) limits the ability of certain taxpayers to deduct passive losses against other types of income. Passive losses are losses that arise from a passive activity. The term “passive activity” is defined as a trade or business activity in which the taxpayer does not “materially participate,” as well as certain rental activities.\(^2\) Section 469(h)(2) provides that, except as provided by Regulations, “no interest in a limited partnership as a limited partner” is treated as an interest with respect to which the holder materially participates.

Pursuant to Regulation section 1.469-5T(a), an individual may establish material participation in an activity under one of seven enumerated tests. However, an individual may establish material participation with respect to an activity of a limited partnership in which the individual holds a “limited partnership interest” only pursuant to three of the seven tests.\(^3\) Consequently, the determination that an individual holds a limited partnership interest limits the individual's ability to establish material participation to one of three, rather than one of seven, enumerated tests.

On November 28, 2011, the Department of the Treasury and the Internal Revenue Service (the “Service”) issued a notice of proposed rulemaking\(^4\) under section 469 (the “Proposed Regulations”).

The Proposed Regulations would modify the current definition of limited partnership interest\(^5\) for purposes of the material participation test of section 469. The Proposed Regulations would provide that an interest in an entity is treated as an interest in a limited partnership as a limited partner if the entity in which such interest is held is classified as a partnership for Federal tax purposes,\(^6\) and –

The 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.\(^7\)

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

\(^2\) I.R.C. § 469(c)(1) and (2).

\(^3\) Reg. § 1.469-5T(e)(1) and (2).


\(^5\) The preamble to the Proposed Regulations states that “the rules concerning an interest in a limited partnership...are provided solely for purposes of section 469 and no inference is intended that the same rules would apply for any other provision of the Code requiring a distinction between a general partner and a limited partner.” 76 Fed. Reg. 72876 (2011). We appreciate and agree with this statement. To ensure this intent is properly carried forward following the issuance of the final Regulations, we recommend that this statement be repeated in the preamble to the final Regulations.


Based on changes in state law and the focus of section 469 on participation and not just management, we recommend that the final Regulations provide that an interest in an entity is “an interest in a limited partnership as a limited partner” if —

1. such interest is an interest in an entity classified as a partnership for Federal tax purposes;

2. the liability of the holder of such interest for obligations of the partnership is limited, under the law of the jurisdiction in which the entity is organized, to a determinable fixed amount; and

3. the rights of the holder of such interest with respect to the entity are restricted solely to (A) ministerial or consulting roles with respect to the entity’s activities and/or (B) the ability to vote on extraordinary matters related to the entity’s activities under (i) the governing provisions of the law of the jurisdiction in which the entity is organized, or (ii) the governing provisions of any agreement qualifying as part of the “partnership agreement” under section 761, including provisions of local law that apply in the absence of agreement otherwise (collectively, the “Partnership Agreement”).

Under this test, any partner that is exposed to unlimited liability will not be viewed as the holder of an interest in a limited partnership as a limited partner regardless of the holder’s ability to participate in the partnership’s activities, thereby ensuring that those partners that are general partners under local law are not viewed as limited partners under section 469. Additionally, this test does not rely on “rights to manage” as the distinguishing factor between limited partners and partners other than limited partners. Rather, this test classifies an equity holder with limited liability as a limited partner for purposes of section 469 only where the role of the holder is restricted to an oversight function. Given section 469’s general examination of all participation in an activity and that many jurisdictions permit owners to participate in the management, conduct, and control of an entity’s business without losing limited liability protection, this test more appropriately permits holders that have limited liability to be classified as other than limited partners if their ability to take part in the management, operation or control of the partnership’s activities is not restricted to an oversight function.

If the final Regulations retain “rights to manage” as the definitional standard, however, we have the following technical recommendations:

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8 Under Regulation section 1.761-1(c), the Partnership Agreement includes provisions of local law as to which the agreement is silent. Note also that a governing provision is a controlling provision. Thus, a provision of local law is not governing if the Partnership Agreement trumps it according to local law. In that case, the Partnership Agreement provision is the governing provision.

9 References herein to “local law” or “state law” are to the laws of the jurisdiction of the partnership’s organization or operation.

10 See, e.g., preamble to Prop. Reg. § 1.469-5(e), 76 FR 72877 (“Under the Uniform Limited Liability Company Act of 1996, LLC members of member-managed LLCs do not lose their limited liability by participating in the management and conduct of the company’s business.”).
1. **Provide clear definition and examples of rights to manage.** We recommend that the final Regulations provide a clear definition of the term “rights to manage,” as well as examples of rights that do or do not qualify as rights to manage. For this purpose, we recommend that the final Regulations provide that the right to bind the entity under local law or under the entity’s governing agreement is a right to manage. Additionally, we recommend that the final Regulations provide that owners that hold themselves out to the public as having the right to bind the entity (including a partner with apparent authority to bind the partnership) should be deemed to have the right to bind the entity under local law.

2. **Clarify that an interest that is a general partner interest under local law does not constitute an interest in a limited partnership as a limited partner.** The “rights to manage” standard implies that a state-law general partner who does not have the “right to manage” may be a limited partner under the Proposed Regulations. We recommend that the final Regulations provide a rule that expressly states that an interest that represents a general partner interest under the law of the jurisdiction in which the organization is organized cannot constitute an interest in a limited partnership as a limited partner. In addition, we recommend that the final Regulations provide that one of the necessary characteristics of a limited partner interest is limited liability protection under the relevant local law.

3. **Clarify interaction of local law and the governing agreement.** As drafted, the language of the “rights to manage” prong of the Proposed Regulations definition is subject to different interpretations, and we therefore recommend that the final Regulations clarify whether the holder of the interest must have rights to manage under both state law and the governing document, or whether having rights under either state law or the governing document is sufficient for the interest to not be viewed as an interest in a limited partnership as a limited partner.

4. **Provide clear definition of the governing agreement.** The Proposed Regulations do not define the term “governing agreement.” We recommend that the final Regulations clearly define this term, and specifically address whether the term includes amendments that arise under state law due to the course of conduct of the parties. We recommend that the Service consider incorporating the definition of “partnership agreement” under section 761(c) by reference, thereby providing taxpayers and their advisors access to an existing framework of existing law.

5. **Clarify that holding rights to manage at all times during ownership period is sufficient.** We recommend that the final Regulations clarify that the absence of management rights during a portion of the entity’s taxable year in which the relevant person was not an owner of the entity will not cause the person to be deemed to hold an interest in a limited partnership as a limited partner.
I. **Background**

Congress enacted section 469 in 1986\(^{11}\) because it was concerned that tax shelters that allowed investors to offset their salary or portfolio income with losses generated by passive investments were eroding confidence in the fairness of the tax system.\(^{12}\) Section 469(a) provides that to the extent that losses from passive activities exceed income from passive activities of certain taxpayers (individuals, estates, trusts, closely held and personal service corporations), the losses are disallowed for all Federal income tax purposes. A passive activity is defined as a trade or business activity in which the taxpayer does not “materially participate,” as well as rental activities.\(^{13}\)

Section 469(h)(1) provides that a taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous, and substantial. Section 469(h)(2) provides that, except as provided by Regulations, “no interest in a limited partnership as a limited partner” is treated as an interest with respect to which the holder materially participates. Congress explained why a limited partnership interest was singled out for restrictive treatment under the newly enacted section 469:

> Because a limited partner generally is precluded from participating in the partnership’s activities, losses and credits attributable to the limited partnership’s activities are generally treated as from passive activities, except that items properly treated as portfolio income and personal service income are not treated as passive.\(^{14}\)

In addition, the legislative history of section 469 indicates that Congress intended that, under Regulations, entities that are “substantially equivalent” to limited partnerships be similarly restricted.\(^{15}\)

The current Regulations divide partnership interests into two classifications: interests that meet the definition of an interest in a limited partnership as a limited partner (“limited partner”) and interests that do not meet that definition. For purposes of section 469(h)(2) and the material participation tests, the current Regulations (the “current limited partner Regulations”) provide that an interest in a partnership is treated as a limited partnership interest if:

1. The interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the

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\(^{13}\) I.R.C. § 469(c)(1) and (2).


holder of such interest for obligations of the partnership is limited under the applicable state law, or

(2) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder’s capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).\(^{16}\)

There are generally seven tests under which an individual who is not a limited partner may establish material participation under the Regulations. To establish material participation in an activity, the taxpayer must satisfy one of the following seven tests each taxable year: (1) the individual participates for more than 500 hours; (2) the individual’s participation constitutes substantially all of the participation in the activity (including individuals who are not owners); (3) the individual participates for more than 100 hours and the individual’s participation is not less than the participation of any other individual (including individuals who are not owners); (4) the activity is a significant participation activity (as defined in Regulation section 1.469-5T(c)) and the individual’s participation in all significant participation activities exceeds 500 hours; (5) the individual materially participated for any five of the last 10 years; (6) the activity is a personal service activity (within the meaning of Regulation section 1.469-5T(d)) and the individual materially participated in the activity for any three preceding taxable years; and (7) based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis.\(^{17}\)

In contrast to a general (or non-limited partner), a limited partner may use only tests (1), (5), or (6) to establish material participation (the “current limited partner tests”).\(^{18}\) A limited partner therefore is subject to a higher standard for purposes of establishing material partnership in the activity of the limited partnership. If, however, the limited partner also holds a general partner interest in the partnership at all times during the partnership’s taxable year, any interest of the holder will not be treated as a limited partnership interest for the individual’s taxable year.\(^{19}\)

II. Changes in State Law

At the time Congress enacted section 469 and Treasury adopted the current limited partner Regulations, the Uniform Limited Partnership Act (the “ULPA”) generally applied and restricted the ability of a limited partner to participate in the partnership’s activities while retaining the protection of limited liability.\(^{20}\) As a result, the limited liability shield provided a useful bright-line test to determine whether a partner was fundamentally passive with respect to the partnership’s activities at that time.

\(^{16}\) Temp. Reg. § 1.469-5T(e)(3)(i).
\(^{17}\) Temp. Reg. § 1.469-5T(a).
\(^{18}\) Temp. Reg. § 1.469-5T(e)(2).
\(^{19}\) Temp. Reg. § 1.469-5T(e)(3)(ii).
\(^{20}\) See ULPA (1916), (1976), and (1986).
Subsequently, the states expanded the types and characteristics of business entities that are available to taxpayers. For example, members of limited liability companies (“LLCs”) all have limited liability with respect to the LLC’s liabilities and have never been restricted in their control or participation in the business of the LLC. Limited liability partnerships (“LLPs”), limited liability limited partnerships (“LLLPs”), and series LLCs are other examples of business entities that did not exist in 1986. In addition, the ULPA has been revised over the years. As revised in 2001, the Revised Uniform Limited Partnership Act (“RULPA”) provides that a limited partner may “participate . . . in the management and control of the limited partnership.”

Although the classification of these new forms of business entities for Federal tax purposes originally was unclear, the check-the-box entity classification regulations, adopted in 1997, clarified the law by permitting taxpayers to choose the classification of eligible business entities.

As a result, entities that bear little resemblance to traditional limited and general partnerships are now classified as partnerships for Federal tax purposes. Additionally, by virtue of the current Regulations’ reliance on the existence of limited liability as the hallmark of a limited partnership interest, members of those entities generally were classified as “limited partners” for purposes of section 469. The Service and taxpayers took different positions on this issue, and the conflict moved interpretation of the current limited partner Regulations to the courts.

III. The Cases

Gregg v. United States was an early case that addressed the section 469 Regulations in the context of LLCs. In Gregg, the court refused to apply the definition in Regulations section 1.469-5T(e)(3)(i)(B) to LLC members because the Regulations had not been updated to take LLC members into account.

The next case was Garnett v. Commissioner, which looked at the rights and obligations of members of LLPs and LLCs, noting that members of both forms of entity were able to participate in the business activities of the entity under state law. As a result, the court determined that it was not appropriate to treat the members as “limited partners” for purposes of section 469.

Subsequently, in Thompson v. United States, the court concluded that, for section 469(h)(2) and the Regulations to apply to a member of a state-law entity, the taxpayer must

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21 In 1986, only one state (Wyoming) authorized the use of an LLC.
22 RULPA, Section 303 (2001).
23 Reg. § 301.7701-1 through -3 of the Procedure and Administration Regulations.
26 87 Fed. Cl. 728 (2009).
actually be a limited partner in a state-law limited partnership.\textsuperscript{27} The Service acquiesced in the result only in \textit{Thompson}\textsuperscript{28} and announced that it would propose new Regulations to define “an interest in a limited partnership as a limited partner” for purposes of section 469.

IV. The Proposed Regulations

On November 28, 2011, Treasury and the Service proposed Regulations (REG-109369-10) to change the definition of a “limited partner” for purposes of section 469(h)(2).

The preamble to the Proposed Regulations states that the rules of the Proposed Regulations propose to redefine an interest in a limited partnership based on the purposes for which section 469 was enacted and the manner in which that section is structured and operates within the Code: “Accordingly, the rules concerning an interest in a limited partnership . . . are provided solely for purposes of section 469 and no inference is intended that the same rules would apply for any other provision of the Code requiring a distinction between a general partner and a limited partner.”

The general rule in the Proposed Regulations is that a limited partner is not treated as materially participating in any activity of a Federal tax partnership, except as provided in Proposed Regulation section 1.469-5(e).\textsuperscript{29} Thus, all income, gain, loss and deduction allocable to a person treated as a limited partner is \textit{per se} passive.\textsuperscript{30}

Initially, the Proposed Regulations provide that the definition of a “limited partner” applies to all interests in entities classified as partnerships for Federal income tax purposes pursuant to Regulation section 301.7701-3 and thus clarify that an interest in an entity such as an LLC or LLP can be a “limited partnership interest” for purposes of section 469.\textsuperscript{31} The Proposed Regulations also provide that the holder of an interest in a Federal tax partnership will be treated as a limited partner if

The holder does not have the right 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.\textsuperscript{32}

The Proposed Regulations provide an exception to the “right to manage” rule. The Proposed Regulations provide that if the individual holds two types of interests in the


\textsuperscript{28} A.O.D. 2010-14 (April 5, 2010).


\textsuperscript{30} As indicated above, we appreciate and agree with the statement that the rules of the Proposed Regulations should apply only to section 469. To ensure this intent is properly carried forward following the issuance of the final Regulations, we recommend that this statement be repeated in the preamble to the final Regulations.


partnership, and one of the interests is not treated as a limited partnership interest as defined above, such as a state-law general partnership interest, the individual will not be treated as a limited partner.33

In the event an individual is considered to hold a limited partnership interest under the foregoing rules, the individual will nevertheless be considered as materially participating in the activity of the partnership if the individual satisfies one of the current limited partner tests to establish material participation.34

V. Recommendations

A. Modify the Standard for Distinguishing Between Limited Partners and Non-Limited Partners

As section 469 analyzes a member’s participation in the operation of the trade or business to which it applies, it is important to define what it means to restrict a member’s right to participate. The Proposed Regulations distinguish between limited partners and non-limited partners solely on the basis of “rights to manage,” thereby substituting “rights to manage” for “rights to participate.” As the preamble to the Proposed Regulations indicates, however, members of entities classified as partnerships for Federal tax purposes often are permitted to engage in the conduct and control of the entity’s business, in addition to the management of the business, without losing limited liability protection under state law. Moreover, the legislative history of section 469 provides that a “limited partnership interest is characterized by limited liability, and in order to maintain limited liability status, a limited partner, as such, cannot be active in the partnership’s business.”35 The preamble to the Proposed Regulations further states that rights to manage include the power to bind.36 As the ability to bind the entity is not equivalent to the ability to manage the entity,37 this statement suggests recognition that “rights to manage” should include certain rights to participate.

Accordingly, it is not entirely clear why “rights to manage” as opposed to “rights to participate in the business activities of the partnership” is the appropriate standard. Moreover, we agree with our colleagues from the New York State Bar Section of Taxation that a rule that classifies a member of a partnership as a limited partner merely because she does not serve a management role, especially where more senior manager members (who may have provided far fewer hours of services) are not classified as limited partners, is difficult to reconcile with the purpose of the statute.38

We therefore recommend that the final Regulations expand the rights of a holder that are taken into account in determining whether the holder’s interest is a limited partnership interest. We also suggest that the final Regulations continue the use of a bright-line test to facilitate administration of a very complex statutory and regulatory regime. In keeping with this intent and the purpose of section 469 generally, and section 469(h)(2) in particular, we recommend that the final Regulations define “an interest in a limited partnership as a limited partner” as one with respect to which the rights of the holder are restricted or limited to an oversight function under the governing provisions of the law of the jurisdiction in which the entity is organized or under the governing provisions of the Partnership Agreement as further explained below.

We suggest that oversight functions be defined as (A) ministerial or consulting roles with respect to the entity’s activities or (B) the ability to vote on extraordinary matters (or both A and B). If this test is adopted, the final Regulations should clearly define “ministerial or consulting roles” and “extraordinary matters.” With respect to the former term, our recommendation is that the definition refer to access and analysis of financial information, supervision of management’s actions, and recommendations related thereto. With respect to the latter term, we recommend the definition refer to those transactions that fundamentally impact the partners’ interests in the partnership, such as a recapitalization, financing, or sale of equity, or that fundamentally impact the partnership’s business, such as the sale of all or substantially all of the trade or business or the partnership’s declaration of bankruptcy. Under this test, the ability to participate in the partnership’s business, whether through the right to manage, the right to control, or simply involvement in the day-to-day operations of the business, would cause a holder to be viewed as other than a limited partner for purposes of section 469.

In addition, a test based on rights granted under state law or governing agreements could lead to a “general partner” being viewed as a “limited partner” for purposes of section 469. The test we recommend in the preceding paragraph would suffer from the same uncertainty. Accordingly, we further recommend that the final Regulations define a “limited partnership interest” to exclude any interest that does not limit the liability of the holder of that interest for obligations of the partnership to a determinable fixed amount under the law of the jurisdiction in which the entity is organized. Although limited liability appropriately is no longer the test for defining which interests are interests in a limited partnership as a limited partner, for the reasons set forth in the preamble to the Proposed Regulations, limited liability remains a meaningful standard for determining which interests are not interests in a limited partnership as a limited partner.

B. Technical Comments if “Rights to Manage” Standard is Retained

In the event that the final Regulations retain “rights to manage” as the definitional standard, however, we have the following technical recommendations.

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39 Generally, restrictions on participation could be imposed by either state law or other legal agreements among the parties. Conversely, grants of rights to participate can emanate from either state law or other legal agreements among the parties. Therefore, so long as the restriction or grant applies, it should be irrelevant which of the two (the state law or legal agreements) impose the restriction or grant the right to participate.

1. Provide Clear Definition and Examples of Rights to Manage

The Proposed Regulations do not contain a definition of the term “rights to manage.” The absence of a definition of this critical term will make the test difficult for taxpayers and tax advisors to apply and will lead to uncertainty. Accordingly, we recommend that the final Regulations provide a clear definition of the term “rights to manage,” as well as examples of rights that do or do not qualify as “rights to manage.”

Additionally, it appears that the Service and the Treasury Department believe that “rights to manage” include the power to bind. If so, we recommend that this concept be included in the text of the final Regulations rather than only in the preamble. For this purpose, we recommend that the final Regulations provide that the power to bind exists if granted under local law or the governing agreement. Thus, for example, if a particular holder would not have the power to bind under local law, but the governing agreement among the members of the entity delegates that power to the holder, the holder should be considered to have rights to manage. Moreover, if an owner of an entity holds herself out to the public as having the power to bind the entity or otherwise has apparent authority to bind the entity, such owner should be deemed to have the power to bind for purposes of this rule.

2. Clarify that an Interest that is a General Partner Interest under Local Law does not constitute an Interest in a Limited Partnership as a Limited Partner

The “rights to manage” standard in the Proposed Regulations creates an implication that there are situations in which a person that is a general partner under state law may be treated as a limited partner for purposes of section 469. For example, a general partner may, under the partnership agreement, be precluded from participating in the management of the partnership’s business pursuant to the commercial arrangement of the parties. We do not believe this person should be treated as a limited partner and recommend that the final Regulations make this clear through a provision explicitly stating that an interest that represents a general partner interest under the law of the jurisdiction in which the entity is organized does not constitute an interest in a limited partnership as a limited partner. Recognizing that the Service may wish to avoid a rule that turns on the labels ascribed by the parties, we recommend that the Service consider a rule, similar to the revised test we set forth above, that provides that one of the necessary characteristics of a limited partnership interest is limited liability. Under this rule, any holder subject to unlimited liability under local law would per se be viewed as a non-limited partner.

3. Clarify Interaction of Local Law and Governing Agreement

The Proposed Regulations provide that an interest is a limited partnership interest if the holder does not have the right 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. This language is subject to different interpretations. One possible interpretation is that the holder of the interest must have the “right to manage” the entity at all times during the tax year under both the governing agreement and state law in order to avoid being treated as a limited partner. However, it is possible that the holder could have the right to manage under the governing agreement for some portion of the tax year and have the power to bind under state law for the remainder of the year. In this context, we are using “bind” to mean create legally enforceable obligations on behalf of the entity.

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41 In this context, we are using “bind” to mean create legally enforceable obligations on behalf of the entity.
limited partner under the proposed Regulations. Another possible interpretation is that “an interest will not be a limited partner if the holder has rights to manage either under local law or under the governing agreement.” These two interpretations of the “right to manage” rule lead to very different results. Considerably more taxpayers would be treated as “limited partners” for purposes of section 469 under the first interpretation than the second. Accordingly, we recommend that the final Regulations clarify whether the holder of the interest must have rights to manage under both state law and the governing document, or whether having rights under either state law or the governing document is sufficient.

4. Provide Clear Definition of “Governing Agreement”

The Proposed Regulations do not define the term “governing agreement.” Because other provisions of the Code contain definitions of the term “partnership agreement” for particular purposes, and given that the term “governing agreement” could be subject to different interpretations (including by reason of the application of local law), we recommend that the final Regulations provide a clear definition of the term. Additionally, because the laws of various jurisdictions permit de facto amendments to governing agreements based on course of conduct, we recommend that the definition of the term “governing agreement” in the final Regulations specifically address whether such amendments under local law are considered for purposes of the section 469 definition of a limited partner interest. For example, certain state laws provide that even if the written agreement among the parties provides that a particular holder cannot take a certain action, if that holder takes the action and the other parties do not object, but rather accept the holder’s action, the written agreement is deemed to be amended based on this course of conduct.

We note that section 761(c) and Regulation section 1.761-1(c) define the term “partnership agreement” and have been subject to administrative and judicial interpretation. We therefore recommend that the Service consider incorporating the definition of section 761(c) by reference, thereby providing clarity and certainty by tying the meaning of that term under section 469 to existing law.

5. Clarify that Holding Rights to Manage at all Times During Ownership Period is Sufficient

Under the Proposed Regulations, to avoid being classified as a limited partner, a holder must have rights to manage the entity at all times during the entity’s taxable year. This rule would unfairly (and, we suspect, unintentionally) subject a holder to limited partner treatment for a particular year in which she was not an owner for the entire taxable year of the entity, even if the holder would otherwise possess “rights to manage” during her entire period of ownership.

43 See e.g. I.R.C. § 761(c); Reg. § 1.704-1(b)(2)(ii)(h).
within the taxable year of the entity. Accordingly, we recommend that the final Regulations clarify that a holder will not be deemed to hold an interest in a limited partnership as a limited partner if the holder has management rights during the entire period of the entity’s taxable year for which the holder was an owner of the entity.