Garnett v. Comm'r., 132 T.C. No. 19 (2009)
Thompson v. United States, [2009-2 USTC ¶50,501] (Fed. Cl. 2009)

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The Tax Court and the Court of Federal Claims recently addressed whether members of limited liability companies ("LLCs") or partners in limited liability partnerships ("LLPs") should be treated as limited partners in limited partnerships for purposes of the § 469 passive activity income tax rules. Both cases held that the respective taxpayers should not be treated as limited partners in limited partnerships notwithstanding their limited liability. [1]

Passive Activity Losses and Credits

Section 469(a) disallows losses and credits from passive activities except to the extent of passive activity income. A passive activity is defined as an activity (i) which involves the conduct of a trade or business and (ii) in which the taxpayer does not materially participate. § 469(c)(1). The issue in *Garnett v. Comm'r.* and *Thompson v. United States* focused on whether the taxpayers materially participated in activities conducted through limited liability companies and limited liability partnerships.

The temporary regulations set forth seven alternative tests for determining material participation. [2] They are:

> (1) The individual participates in the activity for more than 500 hours during such year;
>
> (2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
>
> (3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not

> less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
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> (4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
>
> (5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
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> (6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
>
> (7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Temp. Reg. § 1.469-5T(a).

Irrespective of the foregoing material participation tests, a taxpayer is treated as not participating in an activity if the taxpayer's participation is based upon an interest as a limited partner in a limited partnership, except as provided in regulations. § 469(h)(2). The temporary regulations provide as an exception that the limited partner limitation does not apply if the taxpayer would be treated as materially participating under material participation test (1), (5), or (6) (quoted above) if the taxpayer was not a limited partner. Temp. Reg. § 1.469-5T(e)(2).

The passive activities temporary regulations do not explicitly refer to LLCs or LLPs. However, LLCs and LLPs are generally treated for Federal income tax purposes as partnerships. *See McNamee v. Dept. of the Treasury*, 488 F.3d 100 (2d Cir. 2007); *Littriello v. United States*, 484 F.3d 372 (6th Cir. 2007); *Med. Practice Solutions, LLC v. Commissioner*, 132 T.C. (2009); Reg. § 1.761-1, Reg.; § 301.7701-2(c)(1). The check-the-box regulations permit certain eligible business entities, including domestic LLCs and LLPs, to elect to be treated as corporations rather than partnerships. Reg. § 301.7701-3(b)(1)(i).

In addition, there is no general definition of "limited partner" in the Code or regulations, although regulations were proposed in 1997 with respect to § 1402(a)(13) to define the term "limited partner" for self-employment tax purposes.

Similarly, there is no general definition of "general partner" in the Code or the regulations, although the term "general partner" is used multiple times in the Code and the regulations. In certain contexts, the term refers specifically to a general partner in a limited partnership. *See, e.g.*, § 2701(b)(2)(B)(ii); Prop. Reg. § 1.280G-1, Q&A-7(e), Example (3); Prop. Reg. § 1.368-2(m)(5), Example (8). Most often, however, "general partner" seems to refer broadly to any partner (whether or not in a limited partnership) other than a limited partner. *See, e.g.*, §§ 465(c)(7)(D)(ii)(I), 736(b)(3)(B), 988(c)(1)(E)(v), 6231(a)(7); Reg. §§ 1.42-2(d)(3)(i), 1.904-4(e)(3)(iv), Example (4); Temp Reg. §§ 1.367(a)-1T(c)(3)(i)(A), 1.367(a)-2T(c)(2)(ii).

Notwithstanding the lack of a general definition of limited partnerships, the passive activity temporary regulations provide that a partnership interest is treated as a limited partnership interest if (A) "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 holder of such interest for obligations of the partnership is limited under the applicable State law; or (B) [t]he 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…." Temp. Reg. § 1.469-5T(e)(3)(i).

Garnett v. Comm'r.

Garnett involved activities in seven limited liability partnerships, two limited liability companies, and two ventures characterized as tenancies in common but argued to be *de facto* partnerships. The LLPs and LLCs engaged in agribusiness operations, primarily the production of poultry, eggs, and hogs. In addition to the above entities, there were five "holding LLCs" that owned interests in the LLPs, LLCs and ventures. The entities were organized or registered under Iowa law.

General summaries of the relevant facts concerning the entities, other than the holding LLCs, are as follows:

Seven limited liability partnerships—

One owned by the taxpayer directly.

Six owned indirectly through holding LLCs.

Each Schedule K-1 identified either the relevant holding LLC or the taxpayer as a "limited partner."

The LLP agreements generally provided that each partner would participate in control, management and direction of the partnerships' business.

The LLP agreements generally provided that no partner was liable for partnership debts or liabilities.

Two limited liability companies—

One LLC interest was held directly by the taxpayer as well as through a holding LLC.

The second LLC interest was held through a holding LLC.

Each Schedule K-1 identified the relevant holding LLC or the taxpayer as a "limited liability company member."

The manager was to be selected by a majority vote of the members.

The taxpayer was not a manager of either LLC, but he was a manager of two of the five holding LLCs.

Two ventures characterized as tenancies in common but argued to be de facto partnerships—

- The interests were held indirectly through a holding LLC.
- The holding LLC was identified as a general partner of one of the tenancies in common and as a limited partner of the other.

The IRS asserted that the intervening interests of the holding LLCs should be disregarded, and the taxpayer did not dispute the IRS' assertion. Accordingly, the Tax Court did not address the impact of the holding LLCs.

Principal arguments made by the taxpayer:

The taxpayer argued that the term "limited partnership" should be literally interpreted and limited to entities that are actually limited partnerships under state law. The court observed, however, that Congress likely did not have LLCs in mind when § 469 was enacted, because only Wyoming had an LLC statute at that time. Similarly, LLPs did not exist when § 469(h)(2) was enacted. The legislative history, however, contemplated regulatory authority to treated "substantially equivalent entities" as limited partnerships for purposes of § 469(h)(2).

The taxpayer also argued that he should be treated as a general partner. The taxpayer was not precluded from actively participating in the management and operations of the entities, and the IRS did not dispute that the taxpayer was given at least some role to play in the management of the LLPs and LLCs. The IRS countered that the agreements did not give authority to the taxpayer to take action on behalf of the entities in the capacity of a general partner, and the taxpayer did not function like a general partner. The court observed that the factual inquiry into the taxpayer's authority suggested by the IRS seemed to be akin to the inquiries to be made under the general tests for material participation, and that type of inquiry would blur the rules.

Principal arguments made by the IRS:

The IRS argued that the sole relevant consideration is whether the taxpayer had limited liability with respect to the entities, and thus the interests are limited partnership interests under the temporary regulations. The court observed that the operative condition is not merely that there be an interest in a limited partnership but that the interest be as a limited partner. § 469(h)(2).

The IRS further argued that the general partner exception depends of the extent of the LLP or LLC member's authority and control. A general partner, the IRS argued, means someone who has actual or apparent authority to act for and bind the entity.

The Tax Court's decision:

The Tax Court held that limited liability is not the sole or determinative consideration, although it is one characteristic of limited partners. The rule is not whether there is an interest in a limited partnership, but it is whether there is an interest in a limited partnership *as a limited partner*.

Of greater importance, the court observed that general partners usually have the powers of management as well as personal liability. Most often, limited partners are passive investors, and they lose their limited liability if they participate in management. Thus, the limitation on their participation in a limited partnership's business justifies the presumption that limited partners do not materially participate, and that rationale does not extend to interests in LLCs and LLPs.

As regards LLPs, they are general partnerships that obtain limited liability by filing a registration. Other than the limited liability, applicable general partnership law applies to LLPs. Thus, the Tax Court did not believe that the limited liability rationale should extend to interests in LLPs or LLCs because their members are not barred by state law from materially participating.

The court concluded that, in the case of an LLC or LLP, the general tests for material participation under § 469 are the tests to be applied. LLC and LLP members should be treated as general partners for § 469 purposes, which means that the remaining question was whether the taxpayer materially participated based upon the seven material participation tests.

As regards the tenancies in common, the IRS made no express argument that they should be treated as limited partnership interests, nor did the IRS make an argument that their liability was limited within the meaning of the temporary regulations.

As regards the descriptions of the taxpayer on the K-1's, the IRS argued that the taxpayer obtained a self-employment tax benefit by not being listed as a general partner, but the IRS conceded that the K-1's did not conclusively establish that the interests were limited partnership interests. The IRS did not argue collateral estoppel or the duty of consistency. Neither the notice of deficiency nor the IRS' answer asserted underpaid self-employment taxes. Therefore, the Tax Court held that the inconsistencies were not material under these circumstances.

Thompson v. United States

The taxpayer in *Thompson* formed a Texas LLC to own and operate a single aircraft for air charter services. The taxpayer directly owned 99% of the LLC, and he held the remaining 1% indirectly through an S corporation. The taxpayer was the sole manager.

<u>Principal arguments made by the taxpayer</u>:

Because the LLC is not actually a limited partnership, the taxpayer argued that his interest cannot be that of a limited partner.

Even if the LLC is treated as a limited partnership, his interest was more akin to that of a general partner due to the high degree of control he exercised as its sole manager.

Also, limited partnership statutes generally provide that a limited partner is liable as a general partner if he takes part in the control of the business.

<u>Principal arguments made by the IRS</u>:

The IRS argued that, when the passive activity loss rules were adopted, there was universal agreement among the states that the *sine qua non* of a limited partnership interest was limited liability. Because the taxpayer had limited liability as an LLC member, the taxpayer's interest was identical to that of a limited partnership interest.

The IRS also argued that the LLC should be treated as a partnership because it elected to be taxed as a partnership under the check-the-box regulations.

<u>The decision of the Court of Federal Claims</u>:

The temporary regulations defining an interest in a limited partnership literally requires that the entity be a limited partnership under state law, and the statute applies only to limited partners. § 469(h)(2); Reg. § 1.469-5T(e)(3). Thus, an LLC cannot be treated as a limited partnership, and a member of an LLC cannot be treated a limited partner for passive activity purposes.

The court held that limited liability is not the *sine qua non* of a limited partnership interest for passive activity purposes. The terms “material participation” and “passive activity” demonstrate that Congress’ concern related to the taxpayer's level of involvement in the activity. For example, S corporation shareholders also enjoy limited liability and pass-through taxation, but they are not treated as limited partners for material participation purposes.

Also, LLCs are not “substantially equivalent” to limited partnerships. Unlike limited partnerships, LLCs allow all members to retain limited liability while participating in the business.

The court stated that limited partners are treated differently under the Code because they do not materially participate in their limited partnerships.

As in *Garnett*, the taxpayer’s interest in the LLC was not an interest held as a limited partner in a limited partnership.

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[1] An earlier case, *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Or. 2000), previously held that a member of an LLC formed under Oregon law was not a limited partner for purposes of determining material participation. There, the taxpayer was allowed to combine his participation in the LLC with his participation in a predecessor entity to determine whether he materially participated.

[2] The temporary regulations were promulgated on February 19, 1988, but they have never been made final. The requirement in § 7805(e)(2) that temporary regulations shall expire within three years after the date of issuance only applies to temporary regulations issued after Nov. 20, 1988.