

RENKEMEYER COMPOUNDS THE CONFUSION IN CHARACTERIZING LIMITED AND GENERAL PARTNERS—PART 1

Copyright ©2011, Sheldon I. Banoff.

The evolutionary pressures that led to the adoption of the check-the-box Regulations are continuing to bear against the issue of the federal tax characterization of a “partner” as “general” or “limited.” A recent Tax Court decision highlights the problems and possible solutions.

An ongoing question is who or what, for tax purposes, is a “limited partner” or “general partner” of an unincorporated business entity taxable as a partnership. The answer can result in substantial adverse—or favorable—tax consequences for the members of the tax partnership, under the numerous Code and regulatory provisions that use those terms. For example:

- By operation of Section 1402, an individual member of an unincorporated business entity who already has paid the maximum OASDI portion of the self-employment (SE) tax with respect to other income must pay the unlimited 2.9% HI tax component if she is classified as a “general partner.” Alternatively, a member who is classified as a “limited partner” may avoid that tax on her allocable share of partnership income, but cannot make contributions to a qualified retirement plan with respect to her distributive share of partnership income.
- By operation of Section 469, a tax partner classified as a “limited partner” may not be able to meet the (restricted) material participation tests under Temp. Reg. 1.469-5T, for purposes of the passive activity rules, while classification as a “general partner” would permit the tax partner to satisfy additional, alternative tests not otherwise available.
- A tax partnership may be able to deduct payments (in the year paid) under Section 736(b)(3) to withdrawn or retired members who were deemed “general partners” for purposes of that section, while payments to those members not classified as “general partners” will not be currently deductible.

For the past 32 years, your author has thought about and written on operative provisions of the tax law that, directly or indirectly, focus on the distinction between types of members of unincorporated business entities that are taxable as partnerships.¹ There is surprisingly scant guidance (in the form of statutes, Regulations and other administrative guidance, and case law) addressing this topic. The initial focus was on the tax distinctions between general and limited partners in a limited partnership organized and operated under state law, and it expanded to considering whether the members of other types of state law unincorporated limited liability entities, e.g., LLCs, LLPs, and LLLPs (collectively, along with state law limited partnerships, “limited liability entities” or “LLEs”)² could be shoehorned into either “limited partner” or “general partner” status for tax purposes.

SHELDON I. BANOFF, P.C., is a partner in the Chicago office of the law firm of Katten Muchin Rosenman LLP. A member of the ABA Tax Section’s Partnerships Committee, Mr. Banoff is a frequent contributor to The Journal and co-editor of its Shop Talk column. The author thanks **Robert R. Keatinge, Esq.**, and **Allan G. Donn, Esq.**, for their valuable comments on both state law and tax law aspects of this article.

The identification of issues and the analysis contained in the Tax Distinctions article remain relevant today. Although the 1979 article predated new types of LLEs whose members by statute have the hybrid characteristics of both general and limited partners, that article dealt with the same question that remains unresolved: Do we characterize for various operative federal tax purposes a tax partner as being a “limited partner” or a “general partner” if for state law purposes she exhibits some of the characteristics of a general partner and some of the characteristics of a limited partner?

The Tax Distinctions article, published when the only widely used unincorporated business entities were general and limited partnerships, focused on a putative limited partner who took part in the control of the business and thereby became “liable as a general partner” under section 7 of the Uniform Limited Partnership Act (ULPA) (1916). Pursuant to the terms of the then-applicable statute and the partnership’s limited partnership agreement, that partner had the (limited) rights of a limited partner but the unlimited liability of a general partner by operation of statute (due to his taking part in the control of the business, his contribution being solely of services, or the limited partnership’s use of his name in the business³).

With respect to today’s LLEs, state statutes provide certain general-partner-like rights or powers to certain or all of the members (e.g., granting management and authority rights to all members of member-managed LLCs, managers of manager-managed LLCs, the partners of LLPs, and the general partners of LLLPs), while generally providing limited liability protection to all LLE members (except the general partner of a state law limited partnership). Again, the bedrock issue is this: For purposes of each of the numerous operative provisions of the Code and Regulations, is each type of member of an LLE to be treated as a “limited” or a “general” partner?

The characterization of a member as a “limited partner” or “general partner” may be taking on increased importance in light of the recently enacted Section 1411, which imposes a tax on income that represents a “return on invested capital” for individuals who meet a certain income threshold. Under that section, certain passive or “unearned” income of individuals will be subject to a 3.8% “Medicare contribution” tax beginning in January 2013. The Section 1411 tax was specifically designed to parallel the uncapped HI portion of FICA and SECA taxes that apply to “earned” income. The technical explanation of the provision by the Staff of the Joint Committee on Taxation (JCT) states that the new tax will not apply (among other things) to amounts already subject to the HI portion of the SE tax under Section 1401(b).⁴ It has been observed that the enactment of Section 1411 “further underscores the need for clarification regarding the application of Section 1401 (including the application to a ‘limited partner’).”⁵

In this Part 1, we first describe the nearly century-long state law evolution of LLEs. In preparation for the ensuing tax analysis, it is helpful to understand the evolution of LLEs and the changes in members’ limited liability and level of permissible activity or participation allowable under state law for each form of LLE. The state law evolution of LLEs is interwoven into Exhibit 1, “The ‘General Partner’ and ‘Limited Partner’ Timeline.”

We next identify definitional deficiencies and uncertainties under the tax law in characterizing members of LLEs. We then explore nearly 20 different ways that the terms “limited partner” and “general partner” may be defined for tax purposes. As will be seen, Treasury, the IRS, and the courts have not been consistent in their approaches. We have attempted to identify the merits and weaknesses of each alternative, in our search for the best way to define those terms.

The focus then shifts to how “limited partner” and “general partner” are defined in those Code provisions where either or both of the terms arise most frequently in practice. There is limited guidance (i.e., final or Proposed Regulations, Rulings, and case law) as to the members’ tax status provided under some of these provisions. This leads us to question whether a comprehensive or a section-by-section approach would be the preferred solution.

Part 1 of this article concludes by analyzing the tax law classification of members of LLEs by topic, i.e., the characterization of members of state law limited partnerships, LLLPs, LLCs, and LLPs, respectively, as “limited” or “general” partners for tax purposes.

Part 2 of the article will focus on the Tax Court’s curious opinion earlier this year in *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011). There, the court ruled that members of a law firm operating as an LLP were not “limited partners” for purposes of avoidance of SE tax under Section 1402(a)(13) on their respective allocable shares of the partnership’s income.⁶ The court’s method of analysis may foreshadow how it (and other courts) will characterize members of other unincorporated business entities for purposes of the dozen Code and 70-plus Regulations provisions that provide differing tax consequences for “limited partners” and “general partners.”

If the Tax Court’s methodology is broadly applied to situations other than under Section 1402(a)(13), those members may be characterized as “limited partners” for some tax purposes and “general partners” for others—a logically inconsistent, sometimes unpredictable, but oftentimes appropriate result, in our view. Moreover, by signaling that LLP and LLC members are not automatically “*not* limited partners,” *Renkemeyer* is inconsistent with the analytical method used by the Tax Court (and some other courts) in cases under Section 469.

As will be discussed in Part 2, *Renkemeyer* sheds some light on the Tax Court’s characterization for tax purposes of members of LLPs and other unincorporated entities while simultaneously leaving many questions unanswered, raising additional questions, and creating more than a little confusion. (The AICPA and others have called for regulatory guidance in light of the uncertainty that *Renkemeyer* has added to the treatment of limited partners and LLC members.⁷) *Renkemeyer* also has reignited interest in a topic that percolated politically in the late 1990s—the SE tax liability of state law limited partners who provide services to their partnerships.

Part 2 of this article also will analyze the characterization of members of unincorporated business entities as “limited partners” and “general partners” in light of *Renkemeyer* and other recent judicial developments. We first will analyze *Renkemeyer* with respect to its classification of LLP members for purposes of Section 1402(a)(13). After identifying questions left unanswered by the court’s decision, we will then focus on whether *Renkemeyer* provides guidance for purposes of the classification of members of unincorporated entities other than LLPs under Section 1402(a)(13). Finally, and perhaps most important, we will discuss whether *Renkemeyer* signals how the Tax Court (and perhaps other courts) will classify members of LLEs as limited or general partners for purposes of other operative Code provisions (e.g., Sections 469, 736, 752, 1256, and 6231).

The analysis in Part 2 also will cover recently Proposed Regulations under Sections 469 and 892 that define “limited partners” in a fashion that also may be extended to certain operative Code provisions currently lacking such guidance. Indeed, these new Proposed Regulations may signal that Treasury and the IRS view *Renkemeyer* as justification for abandoning reliance on the state law characterization of members of tax partnerships as being “limited partners” or “general partners” for certain purposes under the Code.

STATE LAW EVOLUTION OF LLEs

Between 1979 and 2001, unincorporated business entities evolved dramatically, including the introduction and expanded use of LLCs, LLPs, LLLPs, and statutory trusts (which may include so-called “business trusts”).⁸ In addition, there have been widespread alterations made to state partnership laws. The original 1916 version of the Uniform Limited Partnership Act (ULPA) had been substantially amended in 1976, was further significantly changed in 1985 (ULPA (1976) with 1985 Amendments), and was amended again in 2001 (ULPA 2001). Changes to the Uniform Partnership Act (UPA), originally adopted in 1914,

occurred with the adoption of the Revised Uniform Partnership Act (RUPA) in 1992, as further amended in 1993, 1994, 1996 (which first featured LLPs), and most recently in 1997.⁹ General partnerships and LLPs are grounded in UPA and RUPA. Unincorporated business entity variants continue to evolve, in many cases on a state-by-state basis.

The state law evolution and development of LLEs also can affect the characterization and treatment of the entities' members for tax purposes. As a result of nomenclature and, in some instances, profound differences in legal structure, it has been difficult to devise a uniform approach to characterizing members of all types of LLEs in all jurisdictions under the myriad federal tax statutes and Regulations.

To illustrate, the variations of limited partnerships permissible under state law have evolved to the point that the limited partner's potential powers, rights, and level of participation in management do not, in many aspects, resemble those of limited partners in limited partnerships originally contemplated by the Code and Regulations.¹⁰ In 2001 Congress was (erroneously) informed by the JCT Staff that under state law, a limited partner normally cannot participate in control of the partnership's business.¹¹

In fact, under many state statutes (having adopted ULPA (2001)), a limited partner now may fully participate in the business of a limited partnership (or LLLP) without incurring liability for claims against the entity. Nevertheless, it is now often difficult to distinguish between active owners of the business and passive investors (see Exhibit 2, "Limitations on Limited Partners' Activities," parts 3-6).

A number of examples involving LLCs illustrate how state law varies the members' powers and rights from those typically found in state law limited and general partnership statutes. For instance, the people who have agency authority and management rights in an LLC may not be LLC members themselves. Conversely, it is possible that no member will have agency or management rights. It also is possible that a member having agency authority will not have management rights and vice versa (unlike general partners). Furthermore, all members of an LLC may participate in the LLC's business without incurring liability for debts and obligations of the entity. Finally, the Uniform Limited Liability Company Act (ULLCA) (2006), enacted to date in Utah and the District of Columbia, eliminates statutory apparent authority, i.e., a member does not have apparent authority to bind the entity by statute solely due to his being a member.

The first generation of LLEs was epitomized by limited partnerships formed under ULPA (1916), in which passive limited partners obtained limited liability as the *quid pro quo* for not participating in the management or control of the partnership's business. The activities that limited partners could undertake without personal liability (other than for their own torts) were substantially increased by the 1976¹² and 1985 versions of ULPA. In all events, however, the general partner(s) of the limited partnership remained personally liable for those debts and obligations for which the partnership was liable ("recourse liabilities"), absent a contractual exculpation of the general partner(s).

The advent of the LLC marked the second generation of LLEs. Those entities generally provide liability protection to all of their members, even those fully participating in the entity's management and operation. LLCs generally are of two basic types:

- The member-managed LLC, whose management in some ways resembles that of a general partnership.
- The manager-managed LLC, whose management somewhat resembles that of a limited partnership.

In Rev. Rul. 88-76, 1988-2 CB 360, a properly formed (manager-managed) LLC received IRS approval for taxation as a partnership under then-applicable Reg. 301.7701-2. The advent of the check-the-box Regulations (Regs. 301.7701-2 and -3) effective after 1996 provided virtual certainty as to the tax treatment of domestic LLCs as partnerships (absent their election to be taxed as corporations).

More recently, LLPs (technically, state law general partnerships whose members are shielded by statute from personal liability for some or all of the partnership's debts), which

first became available in 1991, and LLLPs (technically, state law limited partnerships whose general partners also are shielded from personal liability for some or all of the partnership's debts) have come into vogue. For purposes of this article it is assumed that all LLEs under discussion are taxable as domestic partnerships under the check-the-box Regulations.

CHARACTERIZING LLE MEMBERS: DEFINITIONAL DEFICIENCIES AND TAX LAW UNCERTAINTIES

As the new or modified forms of LLEs gained acceptance and widespread use for business and investment purposes, the tax classification of members of those LLEs as being "general partners" or "limited partners" became relevant and pressing. This was particularly so in areas such as the determination of a member's net SE earnings under Section 1402(a)(13) and issues involving material participation by LLC members for purposes of the passive activity loss limitation rules in Section 469(b)(2) and Temp. Reg. 1.469-5T(e).¹³ Commentators (including your author) have continued to identify issues, propose solutions, and seek administrative guidance or legislation with respect to classifying members of LLCs, LLPs, LLLPs, and other unincorporated entities as being "limited partners" or "general partners" for tax purposes.¹⁴

There has been little progress in identifying the operative distinctions between "general partners" and "limited partners" for federal tax purposes since the 1979 publication of the Tax Distinctions article. There also has been little progress in characterizing as "general partners" or "limited partners" for tax purposes those members of LLEs (other than state law limited partnerships) who are treated as "partners" for federal and state tax purposes.¹⁵ In part, this lack of progress may be directly attributable to actions (and inactions) of Congress, as discussed below. At the same time, other tax and business laws have evolved in a way that places greater stress and importance on these distinctions.¹⁶ One thing that has not changed over the past 32 years: taxpayers still need guidance and tax advisors and return preparers still need to know how to apply numerous operative tax provisions to the owners of LLEs.

In the Tax Distinctions article, written when only traditional general and limited partnerships roamed the earth, we identified four viable approaches to defining "general partner" and "limited partner" for federal tax purposes:

1. By reference to state law definitions.
2. By reference to the partner's limited or unlimited personal liability for obligations of the partnership.
3. By reference to the partner's degree of activity or inactivity in the partnership.
4. By reference to both the partner's personal liability and degree of activity as relevant in the determination.

At that time, we failed to identify several additional approaches, e.g.:

5. By reference to the partner's apparent or actual authority to conduct the partnership's business (even if the partner did not use that authority¹⁷).
6. By reference to the partner's actual or apparent authority or ability to be an agent for notices to the partnership (i.e., notice to a general partner results in notice to the partnership; notice to a limited partner typically does not constitute notice to the partnership).
7. By reference to the partner's ability to dissolve the partnership (in absence of a provision in the partnership agreement to the contrary).

Relevant Tax Definitions

While “partnership” and “partner” are defined in the Code and Regulations for federal tax purposes, “general partner” and “limited partner” are not.¹⁸ Section 7701(a)(2) provides that “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the Code, a trust or estate or a corporation. “Partner” includes a member in such a syndicate, group, pool, joint venture, or organization. “Partnership” is further defined in Reg. 301.7701-2(c) as a business entity with at least two members that is not a corporation under Reg. 301.7701-2(b). “Partnership” and “partner” in Section 761 use the same language as Section 7701(a)(2), and Reg. 1.761-1 defines the terms by reference to the Regulations under Section 7701.¹⁹ There has been surprisingly little judicial interpretation of these terms, and the scant judicial guidance that existed before *Renkemeyer* has been uniformly limited to the particular operative Code provision at hand.

What will depend on an LLE member’s tax classification as a “general partner” or a “limited partner”? Against this backdrop of evolving unincorporated business entities, there currently are 12 provisions in the Code, i.e., Sections 464, 465, 469, 736, 772, 988, 1256, 1258, 1402, 2701, 6231, and 9701, that refer to “general partners” and/or “limited partners.” Of these, Sections 469, 1402, 736, and 6231, as well as the commonly defined Sections 464, 1256, and 1258, are of relatively greater importance in most tax practitioners’ practice, and are analyzed below. Also there are over 80 references to “general partner” and “limited partner” in the Regulations,²⁰ which due to space limitations are beyond the scope of this article.

In addition to those Code sections and Regulations that expressly refer to “general partners” or “limited partners” for operative federal tax purposes, the categorization of partners and members of other unincorporated entities can have meaningful tax consequences in many other situations. Notwithstanding the absence of references to “general partner” and “limited partner” in those other provisions, a person’s status for tax purposes as a “general partner” or “limited partner” (or their respective equivalents), and an analysis of the characteristics used to make those status delineations, can be relevant in determining operative tax consequences under those other provisions.

HOW MIGHT ‘LIMITED’ AND ‘GENERAL’ PARTNER BE DEFINED? LET US COUNT THE WAYS

Given a clean slate, the definitions of “limited partner” and “general partner” for tax purposes could be discerned with respect to members of LLEs in a wide variety of ways. Some focus on the tax partner, some on the type of interest that the partner owns,²¹ and some on the partnership itself. Support exists for each type of classification. There also are other ways to skin the cat. We identify below approximately 20 approaches (including the multiple variations in 2, below), for purposes of thinking about the appropriate definition or combination of definitions of “limited partner” and “general partner.”

1. State Law Characterization Approach

Under this approach, the characterization of the member of the LLE for state law purposes as a “limited” or “general” partner would control for federal tax purposes. With respect to state law limited partnerships, status as a general or limited partner under the applicable state’s limited partnership act would determine the partner’s tax status as a “general” or “limited” partner for all purposes of the Code.

Back in 1979 we observed that it was likely no effort had been made to define “limited partner” and “general partner” in the 1954 Code because the drafters implicitly intended to rely on state law definitions.²² ULPA (1916) predated the 1954 Code by 38 years, and the Code’s failure (as well as that of Treasury and the IRS) to adopt definitions for those classifications gave rise to the inference that the drafters merely intended that the generally accepted meanings of the two terms would apply. We predicted back then

that, as a matter of statutory construction, the courts would be likely to give “limited partner” and “general partner” their common meaning (if one, in fact, exists, which in 1979 we thought was the case) because neither the Code, the legislative history, nor prior judicial construction indicated a different definition.²³

The tax law in 1977, when Section 1402(a)(13) was enacted, supported that deference to state partnership law.²⁴ Indeed, before *Renkemeyer* several cases had held that the determination of whether one is a limited partner under Section 1402(a)(13) was made solely by reference to state partnership law.²⁵

If the partner was a limited partner under state law,²⁶ he was not subject to SE tax under Section 1402(a)(13) regardless of how active he was in the partnership’s business (subject, of course, to state partnership law limitations that could cause the partner to lose limited liability). Conversely, if the partner was not a limited partner under state partnership law, it did not matter how “passive” he was as a state law general partner—he was not a “limited partner” for purposes of Section 1402(a)(13).²⁷ Thus, in *Norwood*, TC Memo 2000-84, RIA TC Memo ¶2000-084, the court noted that the taxpayer-general partner’s “lack of participation in or control over the operations” of the partnership “does not turn his general partnership interest into a limited partnership interest. A limited partnership must be created in the form prescribed by State law.”

A recent New York State Bar Association Report observes that the current statutory framework of Section 1402(a)(13), read alone, allows for differences in the application of the SE tax based on formalistic differences in the choice of entity selected.²⁸ That report states that as things now stand, application of the SE tax to an individual’s share of business income derived by an entity classified as a partnership for tax purposes can vary greatly, based on the state law form of entity that is selected and the state law classification of the individual’s interest.²⁹

Under the State Law Characterization Approach, all of the members of an LLP, which is technically a state law general partnership, would be treated as “general partners” for tax purposes (notwithstanding each member’s limited liability protection deriving from LLP status). With respect to the members of an LLLP, the state partnership law general partner would be treated as such for tax purposes (again notwithstanding his limited liability protection), and the state partnership law limited partners would be deemed “limited partners” for tax purposes.

The State Law Characterization Approach provides no guidance as to the treatment of the members of an LLC taxable as a partnership, as for state law purposes an LLC member is neither a limited partner nor a general partner. To fill the void, the treatment of an LLC member would have to be determined in some other fashion. (As discussed herein,³⁰ several cases illustrate the difficulty in characterizing LLC members under a Comprehensive Approach.)

The State Law Characterization Approach has much appeal, as it is simple to describe and administer. With respect to state partnership law limited and general partners, the only uncertainty is whether a putative state law limited partner’s participation in the control of the business is substantively the same as a general partner (in which event he or she may be characterized for state law purposes as a general partner).

For members of LLPs (who are treated as general partners for state law purposes, despite their limited liability under the LLP portion of their state’s Uniform Partnership Act), however, the State Law Characterization Approach can result in inequitably unfavorable or favorable treatment under those operative tax provisions in the Code and Regulations whose underlying purpose turns on whether the LLE member has limited or unlimited liability for the LLE’s relevant debts. The same observation would apply to the general partner of an LLLP, who would be treated as a general partner for state law (and therefore for tax) purposes, notwithstanding the limited liability shield.

The State Law Characterization approach is deficient with respect to characterizing members of LLCs, business trusts, and other tax partnerships that are not organized and operated under a state law limited or general partnership act.

2. Comprehensive Approach With Uniform Application

A single definition (whatever that may be) could be provided for “limited partner” and “general partner” for all purposes of the Code, whereby every member of an LLE (including members of LLCs and business trusts) taxable as a partnership will be a “limited” or a “general” partner.³¹ A comprehensive approach presumably would be simple and provide ease of administration and tax return preparation, if the two terms’ definitions are in fact definitive, i.e., provide clarity so that taxpayers, their advisors and tax return preparers, and IRS personnel can agree on the application of the two definitions in virtually all instances.

Under this alternative, identifying which members of an LLE would be treated as “general partners” or “limited partners” would be determined using one test for all purposes under the Code. If necessary, Regulations or other guidance could be issued under any section that has unique considerations such that another test or tests would apply, if appropriate, once an owner is characterized as a “general partner” or “limited partner.” Obviously, the question is whether any one formulation will consistently, fairly, and comprehensively result in the “correct” solutions.

If any one test can be found to satisfy these requirements, the advantages of using this approach are obvious. An inherent problem with the Comprehensive Approach With Uniform Application is that by definition it must be broad enough to cover all relevant Code sections, which raises the risk that it may not apply adequately to cover all situations that might occur under each provision. Can any single test satisfy those requirements without being too broad to cover specific sections? Can a single test provide fair and logical results for all operative provisions of the Code and Regulations?

Many factors could be used to identify which members would be treated as “general partners” or “limited partners” for tax purposes. Which test (if any) provides the best overall solution? Specifically, which Comprehensive Approach (1) is comprehensible, (2) is simple to apply and administer, (3) covers all specific sections using either or both of the two terms, and (4) generates the “correct” (fair and logical) results? The following provides a framework for analyzing several alternatives that could be tested under a Comprehensive Approach With Uniform Application throughout the Code.

By reference to non-tax factors that distinguish state law general and limited partners. We might start by identifying and analyzing the rights, duties, and obligations that best distinguish general partners from limited partners under state law. These include:

- (1) Unlimited or limited liability for the partnership’s obligations to third parties.
- (2) Rights to participate in management (or activity) of the partnership.
- (3) Actual level of participation (or activity) in the entity’s business operations.
- (4) Authority to bind the partnership.
- (5) An event of withdrawal with respect to a general partner (and not a limited partner) causes a dissolution or decision to avoid dissolution by the remaining general partners, if any, or a vote to continue the business of the partnership by the other remaining partners.
- (6) Notice to a general partner results in notice to the partnership, whereas notice to a limited partner typically does not constitute notice to the partnership.
- (7) Fiduciary duties owed by general partners to the limited partners may be greater than the fiduciary duties owed by the limited partners to the general partners in that partnership.

Examples of a comprehensive definition based on each of those characteristics that distinguish general partners from limited partners under state law follow, along with our evaluation of each.

Unlimited or limited liability. The most commonly identified distinction between general and limited partners under state law is the unlimited liability of general partners and the limited liability of limited partners for the limited partnership's obligations to third parties. The Service's instructions for Form 1065 provide straightforward definitions of "limited" and "general" partner that are not restricted and thus apparently are intended to apply for all purposes of preparation of the partnership return (and therefore are applicable to all information and transactions that are potentially reportable on the returns of the partnership and its tax partners).

The Form 1065 instructions provide that a "general partner" is a partner who is personally liable for partnership debts. By way of contrast, the instructions provide that, generally, a partner in an LLP is not personally liable for the debts of the LLP (or any other partner), or for the acts or omissions of any other partner, solely by reason of being a partner.³² The instructions provide that a "limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership."³³ Thus, the instructions for Form 1065 apparently focus on unlimited or limited liability as the key or sole characteristic in determining whether a member of a limited partnership is a "general partner" or "limited partner" for tax purposes.

The Comprehensive Approach with respect to LLC members, if based on the existence of liability to third parties, generates a troublesome answer. In *Gregg*, 87 AFTR 2d 2001-337, 186 F Supp 2d 1123 (DC Ore., 2000), the Service argued that *all* members of LLCs should be treated as "limited partners" (for Section 469 purposes) because Temp. Reg. 1.469-5T(e)(3)(i)(B) provides that a partnership interest is treated as a limited partnership interest if the liability of the holder for obligations of the partnership is limited to a determinable fixed amount.³⁴ According to the IRS, for Section 469 purposes *all* members of an LLC will be treated as limited partners of an LLC that is taxable as a partnership—regardless of some or all of the members' unrestricted ability under state law to participate in the control of the business—because of their limited liability under state law. Thus, all members of an LLC would be classified as "limited partners" under Section 469, in the Service's view.

The Comprehensive Approach can just as easily lead to a conclusion that, notwithstanding the LLC members' limited liability to third-party creditors of the entity, all LLC members should be treated as *general* partners, rather than limited partners, at least for purposes of Section 469 and Temp. Reg. 1.469-5T. In rejecting the Service's aforementioned position in *Gregg*, the district court concluded that an LLC cannot be a limited partnership for Section 469 purposes because for state law purposes a limited partnership must have at least one general partner who is personally liable for the obligation(s) of the limited partnership. As stated above, the court reasoned that if, for federal tax purposes, an LLC is treated as a limited partnership, and all members of the LLC are treated as "limited partners" (for purposes of Section 469) because of their limited liability, the consequence of that treatment does not satisfy the state law requirement of there being "at least one general partner."³⁵

In summary, *Gregg* illustrates that if one pursues a Comprehensive Approach to classifying members of LLCs, arguments can be tendered that *all* members of LLCs are to be treated as "limited partners," as contended by the Service, or that *all* members are to be classified as "general partners" (i.e., not "limited partners"), as the court ruled, for purposes of Section 469. The Comprehensive Approach would apply this logic to all provisions of the Code and Regulations that use the phrases "limited partner(s)" and/or "general partner(s)".

No member or manager of an LLE (other than the general partner(s) of a state law limited partnership) has liability to third parties for debts or obligations of the LLE (unless the member consents to the contrary).

It would appear that the absence or presence of limited liability is not an appropriate test under the Comprehensive Approach for deciding whether members of an LLC will be treated as general partners or limited partners.

Rights to participate in management (or activity) of the entity. In state law limited partnerships, the general partner(s) have the statutory right to participate in the partnership's business.³⁶ Conversely, under state law the limited partners do not have the right to participate. Of course, some general partners may not exercise their statutory right; those who act as general partners in order to give their partnerships the benefit of their personal assets standing behind all of the partnership's obligations may or may not meaningfully participate in management or otherwise be actively involved in the partnership's business operations. Nonetheless, all general partners have the statutory right to so participate.³⁷

Could a distinction in defining "limited partner" and "general partner" for tax purposes be based on whether a member of an LLE has the right to participate in the management (or activity) of the LLE? Perhaps it could, and at least some think it should. The 2001 JCT Report³⁸ undertook a broad analysis of various provisions that refer to "general partners" or "limited partners." In general, the JCT Staff determined that "the appropriate update for references to limited partners and general partners would be to substitute a reference to a person whose participation in the management or activity of the partnership is limited under State law (or, in the case of general partners, not limited)."³⁹ Because of the policy implications related to determinations under Section 1402(a)(13), the JCT excluded this provision from its analysis.⁴⁰

Thus, the JCT Staff viewed *the* proper definition of "limited partner" and "general partner" as turning on the presence or absence of rights of a member under state law to participate in the entity's management or activity. Nevertheless, the politics of changing the standard (i.e., from the State Law Characterization Approach that was the political lightning rod when Prop. Reg. 1.1402(a)-2 was issued in 1997) caused the politically neutral JCT Staff to abandon the "appropriate" approach due to "policy implications."

In two sets of Proposed Regulations issued in November 2011, Treasury and the IRS effectively adopted a definitional standard based on the right to manage the entity. In Prop. Reg. 1.469-5(e)(3)(i) (REG-109369-10, 11/25/11), "Passive Activity Losses and Credits Limited," the Treasury proposed that an interest in an entity will be treated as "an interest in a limited partnership as a limited partner" under Section 469(h)(2) if the entity is taxable as a partnership and the holder of such 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."

This standard differs from that described in the 2001 JCT Report, which refers solely to a person whose participation in the management or activity of the partnership "is limited under State law," without reference to not having rights to manage the entity under the governing agreement. Nevertheless, this "no right to manage the entity" variant seems to be the current thinking of Treasury and the IRS for purposes of answering the oft-litigated question of who is a "limited partner" under Section 469(h)(2).

Yet another variant can be found in an obscure provision, Prop. Reg. 1.892-5(d)(iii)(B) (REG-148537-06, 11/2/11), discussed further below, dealing with the similar definition of "an interest as a limited partner in a limited partnership."

Actual level of participation or activity in the entity's business operations. In considering whether a Comprehensive Approach is to be applied for the uniform definitions of "limited partners" and "general partners," we next analyze distinctions pertaining to the members' actual level of participation in the partnership's management, business, or activities.

Some commentators believe that "activity" should be the key factor in distinguishing between the tax status of "general partners" and "limited partners." Unfortunately, using activity or participation as the key distinction raises numerous issues and has significant shortcomings.

The first issue is, what activity should be analyzed? Should the test focus on participation in management of the entity, participation in day-to-day operations of the entity, or some combination of both? Once an appropriate activity is selected, the standards or parameters must be chosen. How much activity is necessary? Examples of standards of activity and participation referred to in the Code and/or Regulations include:

- Active participation in management under Section 464.
- Material participation under Section 469.
- Active participation under Section 469.
- Significant participation under Section 469.
- Material participation under Section 1402.
- Some other measure of performing significant services.⁴¹

The first shortcoming becomes apparent when one tries to apply a partner-level activity test. Several Code sections that refer to “general partners” and/or “limited partners” lend themselves to an activity analysis. Clearly, Sections 448, 464, 1256, and their related Regulations already focus on some level of activity and participation in the affairs of the business. If, however, activity is clearly the issue, the labels “general partner” and “limited partner” become meaningless. Those labels may become meaningful when something other than “activity” is the principal issue.

Indeed, the 2001 JCT Report notes that some have argued that an approach based on actual performance of services would be an appropriate replacement for references to “limited partners” or “general partners.” Originally the reference was a shorthand method of identifying the partner’s level of involvement in the partnership’s business activity. (The 2001 JCT Report mistakes the state law dichotomy under ULPA (1916) pertaining to “participating in the control of the business” for involvement in the partnership’s business activity.) The 2001 JCT Report reasons that if the purpose of the reference in the present-law rules is to identify a partner who not only is permitted under state law to participate in the entity’s business but actually is providing personal services, then a rule defining minimum personal services by hours per year could be substituted for the current “limited partner” or “general partner” reference.

The 2001 JCT Report states it could be argued that an hours-per-year test would be better than a reference to whether the person is limited under state law from participating in management or activity of the entity. It is argued that an hours-per-year test more precisely focuses on the difference between limited and general partners. The report (erroneously) states that in a limited partnership, a limited partner normally has to give up limited liability and become a general partner in order to participate in management or activity of the partnership. Thus, if someone is a general partner in a limited partnership, that person probably is involved in partnership activities. Similarly, if the choice of entity is a general partnership rather than a limited partnership, the liability risk taken on by the partners is the trade-off for the ability to participate in the partnership’s activity. Thus, a general partner is relatively likely to be performing services, having given up limited liability.

This calculus does not apply in the LLC context, however, because the LLC member does not have to give up limited liability in order to have an ownership interest that permits participation in the partnership’s activities. Thus, it is argued, the analogy to a limited or general partner is not complete if one merely substitutes a reference to whether the person is (or is not) permitted under state law to participate in the management or activities of the entity. It is argued that some reference to the LLC owner’s level of personal service for the LLC also is needed. Thus, it could be argued, a minimum number of hours per year of personal service for the LLE would be an appropriate test, providing an easy-to-administer, simple, bright-line test.⁴²

The 2001 JCT Report points out that, on the other hand, an hours-per-year test could be criticized on several grounds. The particular minimum number of hours could be criticized as either too many or too few, depending on the factual circumstances. The same number of hours might not be appropriate for each provision. Another difficulty of a minimum-hours test is that it would impose a recordkeeping burden on taxpayers. They would need to keep a log or other record of their hours, which generally would not be viewed as a simplification (which was the 2001 JCT Report's objective).

In some instances, there could be a perverse incentive to work up to or past the minimum. For example, while escaping "limited partner" treatment would be beneficial to taxpayers under many Code provisions, working significant hours might have the result of subjecting the taxpayer's income from the activity to SE tax (depending on what the test might be under that provision; no recommendation is made in the 2001 JCT Report).

A further concern would be the need for aggregation, or disaggregation, as the case might be, of an individual's services in multiple activities. An aggregation rule would be a complex but probably necessary addition to a minimum-hours test. In addition, it is argued that actually imposing a minimum level of service measured in hours is substantively different from examining the status of a person as a general or limited partner under state law. No such requirement applies to general partners, either as a matter of state law or under federal income tax law, so any attempt to quantify the services that a general partner is likely to perform in any particular instance would alter the substantive results of the affected provisions. Thus, it is argued, trying to assess taxpayers' level of involvement in partnership activities based on an hours-per-year test could be more complex than present law, according to the 2001 JCT Report.

Rather than use a pure hours-per-year test, a Comprehensive Approach to defining "limited partners" and "general partners" could be crafted, using one of the standards of participation described above (e.g., as under Section 464, 469, or 1402). The new approach would be subject to the same gray areas and criticisms that exist under the existing participation tests. Moreover, like any participation-based standard, the partner's level of activity would likely need to be reviewed at least annually, and changes in the level of activity might cause changes in status from "limited partner" to "general partner" (or vice versa), and back again, for all operative purposes of the Code under the Comprehensive Approach. In contrast, if the Comprehensive Approach were applied by reference to any of the six other non-tax factors under discussion that distinguish state law general and limited partners, the unilateral action of the LLE member would not change the member's status as a "general partner" or "limited partner" for tax purposes.⁴³

If "activity" is *not* relevant for purposes of applying any section or Regulation and some other non-tax factor(s) is (are) significant, why should one's level of activity be used to identify whether an owner is treated as a "general partner" or "limited partner" before testing the members under that other factor? For example, a qualifying partnership is eligible for the favorable treatment described under Section 736(b)(3), regarding payments to retiring partners, if (among other things) the recipient is a "general partner," apparently without regard to whether he is active in the business of the partnership or merely a passive investor.

Similarly, the share of partnership income allocable to an active general partner or to a passive general partner will be net earnings from self-employment (NEFSE) under Section 1402(a), regardless of the partner's participation in the business of the partnership (subject to the uncertain application of *Renkemeyer* to that partner). Except for guaranteed payments for services, income allocable to a "limited partner" is excluded from NEFSE under Section 1402(a)(13), regardless of the extent to which the limited partner participates in the business of the partnership (again, subject to the uncertain scope of *Renkemeyer*).

Authority to bind the partnership. If "activity" is not relevant for purposes of a particular Code section that refers to "general partners" or "limited partners," then must not other factors—e.g., authority—be significant? For example, under Section 6231, a general partner may act as the tax matters partner (TMP) for a partnership. The legislative history clearly indicates that the TMP should have the authority to

act on behalf of the partnership and should have the ability to give notice of proceedings to other partners. In this situation, activity is irrelevant and access to records and authority to act on behalf of the entity appear to be the critical factors.

Presumably, a person may have either actual or apparent authority to act in this capacity because, in either event, the person's actions are equally binding on the partnership. Thus, any member of an LLE who has authority to bind the entity with respect to tax matters, whether that authority is apparent or actual and whether that authority is granted under the statute or by agreement among the partners, should be treated as a "general partner" and be eligible to act as a TMP. Any such member also is likely to have access to appropriate records. Thus, testing agency authority may be an appropriate solution, at least for purposes of Section 6231, and may provide a basis for a Comprehensive Approach to distinguishing between members of an LLE.⁴⁴

An illustration of a definition of "general partner" and "limited partner" based on "authority" is the centerpiece of the 1996 Special Report,⁴⁵ which was the basis for the solution endorsed by the American Bar Association Tax Section (the "ABA Proposal").⁴⁶ The essence of the proposal is to classify a person as a "general partner" for tax purposes:

- (1) If he or she has apparent authority to bind the entity when the apparent authority is granted pursuant to the statute under which the entity is formed (which easily can be publicized by a Revenue Ruling),⁴⁷ and
- (2) If a member does not possess apparent authority, then if both (a) the entity is engaged in a field of services enumerated under Section 1202(e)(3)(A) and (b) the member is a member of the entity primarily because of services, skill, or reputation provided or to be provided by the member to the entity.

A person would be classified as a "limited partner" if the person does not have apparent authority to bind pursuant to the statute under which the entity is formed and if the requirements described in (2) above are not satisfied. The proposal was endorsed by the ABA Section of Taxation's Task Force on Limited Liability Companies and submitted in the form of a Proposed Regulation clarifying the status of members of LLEs classified as partnerships for tax purposes. The refined proposal is designed to be simple and easy to administer; in the vast majority of circumstances, members of LLEs could readily determine their proper characterization under these tests. In a few instances, a "facts and circumstances" approach would be required to deal with the status of members of LLEs.

The ABA Proposal also would reach the correct (equitable) results that one would predict in those situations likely to represent the vast majority of scenarios. Proponents of this type of Comprehensive Approach point out that, as drafted in the ABA Proposal, the "correct" result as a matter of policy would arise under Sections 1402(a)(13), 6231(a)(7), 736(b)(3), 448, and 469, which are the provisions whereunder taxpayers and the IRS are most likely to encounter the terms "limited partner" and "general partner" in operation.⁴⁸

The problem with this version of the Comprehensive Approach may be in overcoming the obstacle of its promulgation and acceptance (rather than its effectiveness in operation). In any event, the 1996 Special Report and the ABA Proposal have gained no traction with Congress, Treasury, or the IRS to date. As described in the next few paragraphs, however, in recent Proposed Regulations under Section 469, the "power to bind the entity"—akin to the authority to bind the entity—could be relevant in identifying who is a "general partner" or "limited partner" for purposes of Section 469(h)(2).

Treasury and the IRS recently issued Proposed Regulations regarding the definition of an "interest in a limited partnership as a limited partner." Prop. Reg. 1.469-5(e)(3)(i) provides that one who owns an interest in an entity classified as a federal tax partnership will be treated as owning an interest in a limited

partnership as a limited partner for the individual's tax year if the holder does not have rights to manage the entity at all times during the entity's tax year under the law of the jurisdiction in which the entity is organized and under the operating agreement.

The Preamble to REG-109369-10 (but not the Proposed Regulations themselves) states (incredibly, in our view) that “[r]ights to manage include the power to bind the entity.” This is akin to a Preamble stating that “the color black includes the color white.” There is a world of difference between having the *power* to bind the entity, which may be inherent in the applicable state statute and governing agreement, and the *right* to do so. There also is a world of difference between binding the entity and managing the entity.

For example, a state statute may give each of the general partners of a state law limited partnership the *power* to bind the entity, but the governing agreement (the agreement of limited partnership) may give the *right* to manage the entity to one or less than all of the general partners. Those non-managing general partners do not have rights to manage the entity under the governing agreement, but for purposes of Section 469(h)(2) they will have the power to bind the entity under state law and thus will be deemed “not a limited partner,” i.e., a “general partner” for that purpose.

Effect of member's withdrawal on LLE's dissolution. Some distinctions under state law between limited and general partners may not have viability as being a Comprehensive Approach With Uniform Application for all purposes of the Code, given continuing changes in the business law and developments in tax law. For example, it would be imprudent to base the tax definitions of “general partner” and “limited partner” on the fact that withdrawal of any general partner may cause a dissolution of the entity (in absence of an agreement to the contrary), whereas withdrawal of any limited partner may not.⁴⁹

Notice to a member constituting notice to the LLE. Under state law limited partnership acts, notice to a general partner constitutes notice to the partnership, whereas notice to a limited partner typically does not constitute notice to the partnership. For tax purposes, being an appropriate “notice” partner is one relevant factor for the focus on “general partners” under Section 6231, in the context of the TEFRA rules pertaining to partnership audits (discussed in greater detail below).⁵⁰ Being an acceptable “notice” member (i.e., having the authority to be the designated member to accept service of certain IRS communications on behalf of the entity) does not seem to be of such importance as to warrant determining the tax law definition of “general partner” and “limited partner” by which member, under state law, can get notice on behalf of the entity.

Fiduciary duties owed by one partner to another. For state law purposes, whether pursuant to statute or common law, in some jurisdictions the fiduciary duties owed by the general partners to the limited partners are thought to be greater than the fiduciary duties owed by the limited partners to the general partners in that partnership.⁵¹ The state law aspects of fiduciary duties vis-à-vis the partners (and the partnership) are not well developed or consistent in all jurisdictions, and the tax-related aspects pertaining to fiduciary duties are even less so.⁵²

There is further uncertainty as to the fiduciary duties of members of LLEs (other than state law limited partnerships) and whether they differ in degree or nature among different classes of members in the same entity. In light of these uncertainties, it is inappropriate for the tax law definitions of “general partner” and “limited partner” to turn on the nuances of the fiduciary duties that certain members of LLEs may (theoretically) owe to other members or classes of members of the same LLE.

Summary. Having concluded our analysis of the differing rights, duties, and obligations among state law limited and general partners, would a Comprehensive Approach With Uniform Application using one or more of these distinctions be appropriate and viable? A comprehensive solution likely would result in unintended and inequitable results in some situations. Depending on what standards are used to create the limited/general partner definitional dichotomy and which operative Code or Regulation provision is

applicable, one who is deemed a “limited partner” or a “general partner” for all purposes of the Code may be (choose one or more): chagrined/pleasantly surprised/the beneficiary of an unintended windfall/throttled by the unforeseen ancillary tax consequences of being categorized as a “limited partner” or “general partner” for all purposes of the Code.

Problems with the Comprehensive Approach relate to both its promulgation and its operation. It may take a village to raise a child; by contrast, it apparently takes the entire upper-tier bureaucracies of both Treasury and the IRS to adopt a Regulation. As confirmed by recent anecdotal evidence regarding the promulgation of the Series LLC guidance,⁵³ members of every affected and potentially affected branch, group, or office in Treasury and the IRS (and in some cases, the staff members of congressional tax writing committees) would want to study, weigh in, modify, and potentially veto a comprehensive definition that may affect their areas of influence (“turf wars,” in the vernacular of Chicago street gangs and politicians).

Facing such bureaucratic realities, any comprehensive definition that is ultimately adopted will either be (1) perfect, (2) the lowest common denominator, and/or (3) so extensive and complicated by the time it is promulgated as to be nearly indecipherable and unadministrable. (We have doubts that it would be (1).) As one former high-ranking official has informally stated in connection with a Comprehensive Approach solution: “Be careful what you ask for; you just might get it.”

By reference to partnership-level activities. Alternatively, a Comprehensive Approach With Uniform Application could be based on the nature of the tax partnership’s activities or nature of its business. One might conclude that some or all of the members of personal service organizations (PSOs) should be identified as “general partners” for tax purposes. The Code already identifies certain types of personal service businesses that obtain special (favorable or unfavorable) tax treatment, in situations where it was deemed appropriate to have tax distinctions turn on the classification of the entity’s business activities. Thus, one might establish a Comprehensive Approach whereby all members of designated PSOs operating as LLEs will be treated as “general partners,” and all other members of LLEs will be designated as “limited partners.”⁵⁴

A definitional hurdle would need to be jumped, with respect to exactly what types of entities would be PSOs for this purpose. Definitions are provided in Section 448 (which treats such PSOs favorably by permitting certain of them to retain the cash method of accounting⁵⁵) or in Section 1202(e)(3)(A), which has a different set of PSOs.⁵⁶

A Comprehensive Approach based solely on the nature of the entity’s activities or business would provide ease of administration with respect to those types of trades or businesses that clearly do or do not qualify as PSOs. The harder case may involve defining “limited partners” and “general partners” for entities that either directly or indirectly (through subsidiary LLEs themselves respected as tax partnerships) provide multiple activities or businesses—some as a PSO, some not.

The theoretical advantage of using a PSO approach turns on many of the Code provisions focusing on whether the member or entity is conducting personal services. For example, in the SE tax area, one might contend that any member of the PSO should be treated as a general partner, regardless of level of activity. The disadvantage is that this approach would categorize general partners of entities which are not PSOs as being “limited partners” for all purposes of the Code and Regulations.

A variant of this PSO approach would be to include a second hurdle, to better target those who should be treated as “general partners” uniformly. For example, the entity-level test could be supplemented by treating as “general partners” only those members of a PSO who provide significant personal services to or on behalf of the PSO. The service test would better assure that the individual being targeted as a “general partner” is getting an interest in the LLE for more than merely making a capital investment.

Indeed, as discussed earlier,⁵⁷ only those members of the entity who received their interest primarily because of services, skill, or reputation provided or to be provided by the member to the entity would be included in the definition of “general partner” for tax purposes.

3. Comprehensive Approach With Specified Exceptions

A variant of the Comprehensive Approach in alternative 2, above, is to use uniform definitions of “limited partner” and “general partner” except in situations where one or more specified exceptions are appropriate. The specified exceptions would be those provided explicitly to the contrary by the Code or Regulations, and thus the list could expand or contract as operative tax law provisions using “limited partner” or “general partner” further evolve, as well as the types of LLEs.

4. Comprehensive Approach Based on State Law Characterization With Exceptions

A variant of the two approaches in alternatives 1 and 2, above, is to base the definition on a state law characterization approach (as in alternative 1) and apply it on a comprehensive basis, but provide for specific exceptions (as in alternative 3).

An example of this hybrid approach is found in the Form 1065 instructions. A “limited partner” is first defined there as a partner in a partnership formed under state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership. If the definition had stopped there, this would be the Comprehensive Approach, similar to that used in the instructions to define “general partner,” as described above.⁵⁸ Moreover, this also would fall within the State Law Characterization Approach used in alternative 1, above, because a limited partner’s status as such under state law would control the partner’s characterization as a “limited partner” for federal tax purposes.

Nevertheless, the Form 1065 instructions go on to provide for exceptions to the State Law Characterization Approach, and contain one specified exception to the “rule” that to be a “limited partner” for tax purposes, one must be a state law limited partner. The instructions further provide that “some members of other entities, such as domestic or foreign business trusts or [LLCs] that are classified as partnerships, may be treated as limited partners for certain purposes. See, for example, Temporary Regulations 1.469-5T(e)(3), which treats all members with limited liability as ‘limited partners’ for purposes of section 469(h)(2).”

As so embellished, the instructions for Form 1065 create uncertainty not only for members of LLCs (who may be treated as limited partners *forcertain* unspecified purposes and presumably as “not limited partners” (i.e., general partners?) for other unspecified purposes) but also for members of LLPs and LLLPs, for whom the instructions provide no guidance. No news may be good news; no news may be bad news. Here, no news may be merely no news, and members of LLPs and LLLPs may be craving guidance as to their status for tax purposes.

5. Section-by-Section Approach Based on the Operative Provision’s Underlying Purpose

Under this alternative, the taxpayer and IRS would need to divine the legislative intent of the operative Code or Regulation provision that contains the “limited partner” or “general partner” reference, and then determine whether the LLE member should be treated as a “limited partner” or “general partner” for purposes of that operative provision. As will be discussed later in this article, the Tax Court in *Renkemeyer* effectively applied this approach and determined the underlying legislative intent of Section 1402(a)(13) is to treat (for purposes of that section) as other than a “limited partner” an LLP member who generated virtually all his allocable share of the LLP income from his services to the LLP in his capacity as a partner, having made no significant capital investment in the LLP.

Under this approach, each Code section is examined and its goals and purposes are determined. Appropriate tests are then devised for each section to implement these goals and purposes. Notwithstanding the Form 1065 instructions, Treasury and the IRS seem to have adopted a section-by-section approach, attempting to issue guidance limited solely to the operative tax provision at hand, with classifications that are often inconsistent with those of other Code or Regulation provisions.

As a result of the section-by-section alternative, the same partner can be characterized as a general partner for some purposes and a limited partner for others. IRS used the Section-by-Section Approach in 1995 in defining “general partner” for purposes of the entity-level tax classification tests under Section 7701.⁵⁹ In 1994 and 1997, Proposed Regulations were issued to classify limited partners for the SE tax purposes of Section 1402(a)(13).⁶⁰ In 1996, Reg. 301.6231(a)(7)-1 defined which members of an LLC would be treated as a “general partner” for purposes of the TMP provisions of Section 6231. None of these examples profess to define “general partner” or “limited partner” for all purposes of the Code—only for the provision at hand.

The Section-by-Section Approach has several advantages. Assuming one can identify the objectives and purposes of each section, a section-by-section analysis should generate the “correct” result under each Code provision. Moreover, it is substantially more likely that guidance will be generated by Treasury, the IRS, or the courts section-by-section or case-by-case, rather than via a unified, global solution as to the characterization of all members of all LLEs for all Code purposes—a solution for which those who await Godot still will be waiting under the Internal Revenue Code of 2054.

The disadvantages of the Section-by-Section Approach are significant. First, it is not a simple solution. It may be difficult to determine the “correct” intent, objective, purpose, and solution for each section. Further, there may be more than one “appropriate” solution for each section, which adds complexity and makes any set of solutions more difficult to administer.

For example, while the approaches used in Prop. Reg. 1.1402(a)-2 and Reg. 301.6231(a)(7)-2 are substantially similar, dramatically opposed results may occur under those provisions given similar facts and circumstances. Both sets of rules focus on management authority in determining whether a member will be treated as a manager or as a person who is not a manager (i.e., as a “general partner” or as a “limited partner”). Yet, if an LLC is a manager-managed LLC and it has no member-manager, all members are treated as “*limited* partners” for purposes of the Proposed Regulations under Section 1402, while all members are treated as “*general* partners” for purposes of the Regulations under Section 6231. Both conclusions may be “correct,” yet it is awkward and confusing—and, arguably, potentially harmful to tax administration—to apply the same principle to two sections and reach different conclusions.⁶¹

Another problem with the Section-by-Section Approach is that, because different tests are applied to each section, it is more likely that taxpayers may structure solutions to achieve different tax consequences. The resulting tax system would be less administrable and probably would overemphasize tax planning in the choice of entity. For example, the legislative history of Section 469 indicates Congress believed a limited partner presumptively could not participate in the business of the partnership to the extent necessary to “materially participate.” Applying an activity test to members of an LLC would result in a greater likelihood that members of an LLC might satisfy a participation test, and for this reason taxpayers might select one structure over the other. But some of the LLC members (who clearly would qualify for avoidance of SE tax liability under Section 1402(a)(13)) might prefer to be limited partners in a state law limited partnership.

Finally, administration of this alternative is inherently more complex, difficult, and expensive because there would be several tests to apply. Obviously, however, the Section-by-Section Approach may be the only option unless an alternative that is simpler, fairer, and easier to administer is available.

As described in Part 2 of this article, this alternative also is open to a number of unanswered questions that make it difficult to administer in certain situations. This alternative also can result in anomalous situations where a state partnership law limited partner is treated as a general partner (or at least not treated as a limited partner), depending on the legislative intent of the operative Code provision. This method also leaves open for interpretation the legislative intent underlying each particular Code and Regulation provision. Notwithstanding these criticisms, reference to the operative Code provision's legislative intent may be the most equitable approach, at least where that intent can be readily identified.

6. Section-by-Section Approach Based on Date of Enactment

Another way to define "limited partner" and "general partner" would be to (1) identify the operative Code provision, (2) determine the date the applicable language (using "limited partner" and "general partner") was embedded in that Code provision, and then (3) determine whether the taxpayer's type of LLE was in substantial use at the time so identified.

If the taxpayer's LLE was in fairly widespread use, we could apply the statute accordingly (e.g., a strong presumption that the applicable Code provision was contemplated as applying in some fashion to at least some of the members of such types of LLEs). If the type of LLE whose interest was then owned by the taxpayer was *not* in fairly widespread use, the strong presumption would be that the statutory language was never contemplated to apply to the taxpayer's interest in the LLE.

This alternative finds some support in *Garnett*, 132 TC 368 (2009). There, the Service attempted to disallow the taxpayer-partner's allocable share of losses from his LLP on the grounds that he was a "limited partner" under Section 469 for purposes of the passive loss rules, even though under state law the LLP was a general partnership whose partners had certain personal liability protections. The Tax Court suggested that because only one state permitted LLC status in 1986 when Section 469 was enacted, and there were no LLPs in existence until 1991, Congress in 1986 could not have meant for the rules involving "limited partners" to have applied to LLC and LLP interests.

This Section-by-Section/Date of Enactment Approach also can be supported by dictum in *Renkemeyer*. The Tax Court observed that Section 1402(a)(13) originally was enacted in 1977, before entities such as LLPs were contemplated, and the applicable statute did not (and still does not) define a "limited partner." Indeed, LLCs and LLLPs also did not come into widespread use for many years after the 1977 enactment date.

What should be the consequence of the relevant Code provision's being enacted before or after the taxpayer's particular type of LLE became popularly used? Could it be argued that Congress should be imputed knowledge of the widespread use (or lack thereof) of the LLE? In that event, by ascribing operative tax consequences to "general partners" or "limited partners," should the state law labels be given dispositive effect for members of those types of LLEs that were already in widespread use? For those little-used (e.g., series LLCs) or as-yet "unborn" types of LLEs, however, should the state law labels be disregarded and some other standard (e.g., divining the legislative intent behind the operative Code provision) be applied? As was discussed earlier, a court made much of the fact that LLCs were not in widespread use in 1986 when the passive loss rules in Temp. Reg. 1.469-5T(e) provided certain adverse tax consequences to "limited partners." That court held that the LLC and LLP members were not "limited partners" under Section 469 because they were not state law limited partners.⁶²

It is submitted that this alternative creates distinctions in tax treatment that turn on whether Congress "contemplated" a particular type of LLE, or when the latter gained widespread use. In some situations there may be uncertainty as to when those events occurred. For example, who can say with confidence that when Congress used "general partner" in Section 736(b)(3) in 1993, LLCs were or were not likely to have been known to Congress for purposes of including or excluding any or all of an LLC's members from

coverage? Shortly after the enactment of Section 736(b)(3) that uncertainty was being raised by your author, other commentators, and (more important) professional service firms which chose *not* to become LLCs because of that uncertainty.⁶³

As described herein, neither the Code provision nor its legislative history indicates which LLC members (if any) should be treated as “general partners” for this purpose. The timing of the 1988 approval of the LLC format for tax classification purposes (pursuant to Rev. Rul. 88-76), the widespread enactment of LLC statutes during the next ten years, and the enactment of Section 736(b)(3) in 1993 make this “Date of Enactment” alternative of no predictive value as of 1993.

Moreover, if the unincorporated business in question was formed in Delaware, it could be an LLC at the date of enactment (1993), but if it was an Illinois business it could not be formed and operated in Illinois until on or after 1/1/94 (the effective date of the Illinois LLC Act). The applicability of the Section-by-Section/Date of Enactment Approach should not turn on whether the type of LLE could or could not be formed in the taxpayer’s state of residence or the LLC’s place of principal business for the tax years at issue—that is too complex to administer.

To complicate matters, we think it highly unlikely that Congress was aware of the dates of evolution of the various types of LLEs (including when revised uniform acts pertaining to the various types of LLEs were adopted by NCCUSL or enacted by a meaningful number of states, oftentimes not until years or decades after NCCUSL had adopted the uniform act). The timeline in Exhibit 1 notes many dates of evolution for differing types of LLEs, and the various dates that Code provisions using “limited partner” and/or “general partner” were enacted, but we can reach no clearly correct answer as to what date each type of LLE gained “widespread use” or whether Congress would possibly have known those dates at the time of enactment.

All in all, this Section-by-Section/Date of Enactment Approach does not have great appeal for resolving the tax law definitions of “general partner” and “limited partner.”

7. By the Source of the Allocable Share of Income (Capital and/or Services)

Still another way to define “limited partner” and “general partner” for tax purposes would be to revert to the traditional (first-generation LLE) distinctions found in state law limited partnerships.

Back then, the general partner typically received the partnership interest (including any carried interest) in return for rendering services to the partnership; the limited partner ordinarily received that interest in exchange for a capital contribution. Of course, many general partners contributed capital, as well (sometimes taking back a separate limited partner interest in exchange therefor).

Under this Source of Income Approach, the characterization of members of LLEs other than limited partnerships would be based on a similar services/capital dichotomy. Thus, manager-members of LLCs receiving a profits or capital interest for services would be “general partners” for tax purposes; nonmanaging members of LLCs receiving their interests for cash or property contributions would be “limited partners.”

This alternative is supported by the analysis found in *Renkemeyer* with respect to characterization of members for purposes of Section 1402(a)(13). The problems and uncertainties of the Source of Income Approach mirror those that will be discussed in Part 2 with respect to *Renkemeyer*.

Early in December 2011, the ABA Section of Taxation submitted its “Options for Tax Reform in the Partnership Tax Provisions of the Internal Revenue Code,” as part of a series of reforms designed to improve the tax laws and to make them simpler to understand and administer. The ABA Tax Section again recognized that the statutory language of Section 1402(a)(13) is outdated since it does not address the

tax treatment of legal entities such as LLCs. In addition, partners who provide both services and capital to a tax partnership have no definitive guidance to determine which portion of their income is subject to SE tax liability. The ABA Tax Section recommended consideration of the following: “amend Section 1402(a)(13) to focus on whether income is attributable to services provided or capital contributed to a partnership (rather than state law labels) and to provide that income that is attributable to capital is not subject to SECA.” Under this legislative solution (which presumably would eliminate rather than clarify the meaning of the terms “limited partner” and “general partner”), “Treasury would be given the regulatory authority to provide clear rules and safe harbors under this section.”

8. By Deference to Treasury/IRS Guidance in Prop. Reg. 1.1402(a)-2

Yet another alternative would be to defer to Treasury or IRS guidance (issued in the form of Regulations, Rulings, Notices, or other published pronouncements) absent any statutory elaboration of the meaning of “limited partner” and “general partner.”

The Tax Court (and other courts) might gladly defer to explicit regulatory guidance on point.⁶⁴ The Tax Court in *Renkemeyer* referred to the 1997 proposed rulemaking under Section 1402(a)(13) in the court’s search for meaningful guidance.⁶⁵ In light of controversy and subsequent events, however, there was no revision or finalization of those Proposed Regulations. The court noted that neither Congress nor Treasury had issued any other pronouncements with respect to the definition of “limited partner” for SE tax purposes, and therefore the court was “left to interpret the statute without elaboration.”

One might speculate that, had Regulations defining a “limited partner” for SE tax purposes been in place for the tax years in litigation, the court would have cloaked itself with such a Regulation in determining whether the attorney-partners in *Renkemeyer* were liable for SE taxes.

Even absent finalized Regulations under Section 1402(a)(13), a court could choose to apply the approach used in Prop. Reg. 1.1402(a)-2 to characterize members of LLEs as “limited partners” or “general partners.” The courts are by no means precluded from relying on a Proposed Regulation (or even the Preamble to a Proposed Regulation) in determining the outcome of a case, and indeed have so relied when it served the court’s purposes to do so.⁶⁶ Although Prop. Reg. 1.1402(a)-2 was a lightning rod for controversy in 1997-98, its approach then was criticized much more as a matter of policy⁶⁷ than on technical grounds.

The issuance of Prop. Reg. 1.1402(a)-2 addressed the issue of “limited partner” and “general partner” classification for all tax partnerships regardless of the state law characterization of the unincorporated entity. State law characterization of a person as a limited or general partner or a member of an LLC is irrelevant. Rather, the Proposed Regulation focuses on the relationship (and activities) of the partner, the partnership, and the partnership’s business.⁶⁸

Under Prop. Reg. 1.1402(a)-2(h), a person is treated as a “limited partner” for purposes of Section 1402(a)(13) unless (1) he has personal liability under Reg. 301.7701-3(b)(2)(ii) for the debts of the enterprise, (2) he has statutory authority to contract on behalf of the entity, or (3) he participates for more than 500 hours in the tax partnership’s trade or business.⁶⁹ A special rule applies to members of a service partnership: any rendition of services for the partnership will preclude the member’s having “limited partner” status.

Under the Proposed Regulations, even if the member is not classified as a “limited partner,” if he holds more than one class of interest he may bifurcate his ownership interests and not recognize NEFSE if other members owning a substantial (i.e., 20%) interest of that class of interest with similar rights are classified as limited partners. Similar treatment is available for similarly situated individuals who fail to achieve “limited partner” status solely because of their participating that year for more than 500 hours in the tax partnership’s trade or business. The intention of the Proposed Regulations is to exclude from SE tax a tax partner’s returns on capital invested in the entity.⁷⁰

Prop. Reg. 1.1402(a)-2 does not appear to apply to a state law general partner of a state law general partnership, LLP, or LLLP because under UPA, RUPA, and ULPA, respectively, a general partner always has at least apparent authority to contract on behalf of the partnership.⁷¹

9. By Deference to Treasury/IRS Guidance in Prop. Reg. 1.1402(a)-18

Alternatively, a court could choose to revert to the “member’s role in management” approach taken in Prop. Reg. 1.1402(a)-18, which was designed to characterize LLC members as “limited partners” or “general partners” under Section 1402(a)(13).⁷² Although it would be virtually unheard of for a court to “rely” on a withdrawn Proposed Regulation, the three-prong approach taken in Prop. Reg. 1.1402(a)-18 conceivably could be adopted by a court in deciding the merits of a case.

The essence of Prop. Reg. 1.1402(a)-18 is a general rule and a controversial exception. The general rule is that an individual’s NEFSE includes the distributive share of income (or loss) from any trade or business carried on by an LLC of which the individual is a member. As an exception, Prop. Reg. 1.1402(a)-18(b) provided that, for purposes of Section 1402(a)(13), a member of an LLC will be a “limited partner” only if (1) the member is not a manager of the LLC, (2) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction, and (3) the member could have qualified as a limited partner in that limited partnership under state law.

The bedrock of Prop. Reg. 1.1402(a)-18 has been described as being that the distributive share of a member who has the right to make management decisions is NEFSE (i.e., the member is not a “limited partner”) and the distributive share of a member who lacks such right is not NEFSE (i.e., the member is a “limited partner” for this purpose). The focus is on the member’s rights or role in the management of an LLC, rather than on whether the member derives income from services provided to the LLC, in determining whether the member’s distributive share of LLC income is subject to SE tax.⁷³

Treasury acknowledged that public comments on the 1994 Proposed Regulation were “mixed.” Some commentators on Prop. Reg. 1.1402(a)-18 reportedly were pleased with the attempt to conform the treatment of LLCs with state law partnerships.⁷⁴

Although Prop. Reg. 1.1402(a)-18 was proposed with good intentions, it was withdrawn for good reasons. The aforementioned exception (to allow an LLC member to be a “limited partner” under Section 1402(a)(13)) contained both a “limited partnership equivalency” test (i.e., whether the entity, e.g., a law firm LLC, “could have been formed as a limited partnership rather than an LLC in the same jurisdiction”) and a “limited partner equivalency” test (i.e., whether the member “could have qualified as a limited partner in that limited partnership under applicable law”).⁷⁵

The Preamble to the 1994 Proposed Regulation stated that the limited partnership equivalency requirement responded to a concern arising from the fact that some states prohibit the conduct of certain activities through partnerships generally or limited partnerships in particular. Thus, a business operating through an LLC cannot obtain a result for SE tax purposes that it would not be able to achieve by operating as a limited partnership. Unfortunately, for some entities, e.g., law firm LLCs, it was unclear whether the firm “could have been formed as a limited partnership.” This uncertainty could lead to anomalous results.⁷⁶

Similarly, the “limited partner equivalency” test in Prop. Reg. 1.1402(a)-18 was well-intentioned but fatally flawed. Under that test, if the member of the LLC could not have qualified as a limited partner in a limited partnership under state law, Section 1402(a)(13) could not, by definition, apply. Therefore, to retain a level playing field between LLCs and limited partnerships, the Proposed Regulation sought to treat the member like a “general partner” (rather than a “limited partner” under Section 1402(a)(13)). According to the Preamble to the 1994 Proposed Regulation, under state law a limited partner may become liable for the obligations of a limited partnership as a general partner when the limited partner participates in

the management or control of the business. Thus, the “limited partner equivalency” requirement was intended to ensure that both a member of an LLC and a limited partner in a limited partnership who participate in the management or control of the entity to the same extent are treated in the same manner for SE tax purposes.

As noted, this premise (that an overly active partner could lose his limited liability shield) was fatally flawed. ULPA (1916) section 7 provides that a “limited partner shall not become liable as a general partner unless, in addition to the existence of his rights and powers as a limited partner, he takes part in control of the business.” As described in Exhibit 2, however, the standard changed under ULPA (1976) and then even further under the 1985 Amendments to ULPA (1976), which in ULPA section 303(a) provide that a limited partner who participates in the control of the business is liable *only* to persons who transact business with the limited partnership reasonably believing, based on the limited partner’s conduct, that the limited partner is a general partner. Thus, it appears under ULPA’s 1985 version of section 303(a) that an attorney who is a limited partner in a state law limited partnership law firm could avoid liability as a general partner by holding himself out to the public as a limited partner (e.g., on letterhead and websites, and by signature on documents), and by never signing documents or holding himself out as a general partner.⁷⁷ As the 1985 version of ULPA predated Prop. Reg. 1.1402(a)-18 and its Preamble by nine years, and a number of states had adopted or were in the process of adopting the 1985 version of ULPA by the time the Proposed Regulation was promulgated late in 1994, it is easy to understand why the Proposed Regulation did not gain traction.

Other weaknesses inherent in Prop. Reg. 1.1402(a)-18 were quickly identified.⁷⁸ It became widely recognized that these Proposed Regulations would need major retooling, leading to their withdrawal in 1997. They are not worthy of resurrection today.

10. By Deference to Treasury/IRS Guidance Under Other Code Provisions

A variant of reliance by a court on either set of Proposed Regulations under Section 1402(a)(13) would be judicial deference to Regulations interpreting “limited partner” and “general partner” issued under Code provisions other than Section 1402(a)(13). Is this a viable approach?

One commentator recently expressed the viewpoint that the rules of Temp. Reg. 1.469-5T(e) could be applied to LLCs and to partnerships to differentiate investment earnings from active earnings for NEFSE purposes.⁷⁹ Treasury and the IRS long ago promulgated Temp. Reg. 1.469-5T(e)(3), which treats all members with limited liability as “limited partners” for purposes of Section 469(h)(2).

There is no indication in *Renkemeyer* that the court gave any consideration to applying by analogy the rules of Section 469(h)(2) and the Regulations thereunder to Section 1402(a)(13). This effectively confirms that the Tax Court (and other courts) may give no deference to Treasury and IRS guidance issued under other Code provisions (namely, Temp. Reg. 1.469-5T(e)(3)) in attempting to devise the meaning of “limited partner” and “general partner” for the particular case at hand.

Even if Treasury and the IRS issue guidance (e.g., in the form of a Regulation) as to the meaning of “limited partner” and “general partner” under the same operative Code provision that may affect a similarly situated taxpayer, it would be wise for the taxpayer and the courts (should the matter be litigated) not to give undue deference to the Temporary Regulation’s definition or position on point. In several cases decided in the past few years, different courts have rejected the Service’s position that a working member of an LLC was not entitled to be treated like a “general partner” for purposes of Temp. Reg. 1.469-5T. Indeed, it now appears far more likely that Treasury would modify its Regulation (as proposed by Treasury on 11/25/11, or in some variant form) than the courts would defer to Temp. Reg. 1.469-5T(e).

There is some guidance of limited scope and value as to who is (or “is treated as”) a “general partner” or “limited partner” for the specific provision at hand. For example, for purposes of Section 6231(a)(7), relating to the designation of the TMP in TEFRA audit proceedings, Reg. 301.6231(a)(7)-2 provides that a member of an LLC will be treated as a “general partner” if that member, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed.

The scope of that Regulation and Section 6231(a)(7) is limited, and focuses on treating as “general partners” those LLC members having the necessary authority and access to records needed to act as a TMP.⁸⁰ That is not the focus of other Code provisions using “limited partner” and “general partner,” and thus the guidance contained in Reg. 301.6231(a)(7)-2 should not be broadly applied throughout the Code.

In early November 2011, Treasury issued Proposed Regulations under Section 892 that define an “interest as a limited partner in a limited partnership” solely for purposes of an exception to the partnership attribution rule contained in Temp. Reg. 1.892-5T(d)(5).⁸¹ An interest in an entity classified as a partnership for federal tax purposes will be treated under Prop. Reg. 1.892-5(d)(5)(iii)(B) as “an interest as a limited partner in a limited partnership” if the holder of such interest does not have rights to participate in the management and conduct of the partnership’s business at any time during the partnership’s tax year under the law of the jurisdiction in which the partnership is organized or under the governing agreement.

The Proposed Regulation (correctly, in our view) carves out certain rights that state law limited partners typically have held without jeopardizing their limited liability status. The Proposed Regulation states that rights to participate in the management and conduct of a partnership’s business do not include consent rights in the case of extraordinary events such as admission or expulsion of a general or limited partner, amendment of the partnership agreement, dissolution of the partnership, disposition of all or substantially all of the partnership’s property outside of the ordinary course of the partnership’s activities, merger, or conversion.⁸²

Particularly noteworthy is the Proposed Regulations’ inclusion of certain members of LLCs (and other LLEs) as “a limited partner in a limited partnership.” If this definitional approach were broadly applied, one would *not* have to be a member of a state law limited partnership to be treated as a “limited partner in a limited partnership” for tax purposes.

Treasury and the IRS, however, expressly limit the scope of Prop. Reg. 1.892-5(d)(5)(iii). The Preamble to the Proposed Regulation states that “[t]his definition of an interest as a limited partner in a limited partnership applies solely for purposes of this exception [to the partnership attribution rule of Temp. Reg. 1.892-5T(d)(3)], and no inference is intended that the same definition would apply for any other provision of the Code making or requiring a distinction between a general partner and a limited partner.”

Your author was unaware of any other provision defining an “interest as a limited partner in a limited partnership” in the fashion described in Prop. Reg. 1.892-5(d)(5)(iii)(B). At their issuance on 11/3/11 we wondered: might this be the Service’s new way to define the concept of a “limited partner,” for use in other Code provisions? Note a somewhat similar term that appears in Section 469(h)(2), which provides that “no interest in a limited partnership as a limited partner” will be treated as an interest with respect to which a taxpayer materially participates.

On 11/25/11—only 22 days after issuing the Section 892 Proposed Regulations—Treasury and the IRS issued Prop. Reg. 1.469-5, redefining who holds an interest in a “limited partnership as a limited partner” for purposes of the material participation rules in Section 469(h)(2). As discussed earlier, the language of Prop. Reg. 1.469-5(e)(3)(i) contains a slightly different definition of “limited partner” than is found in the Section 892 Proposed Regulations, and the Preamble to the Section 469 Proposed Regulations states

that a member's rights to manage include the power to bind the entity (a concept not found in the Section 892 Proposed Regulations or Preamble). Moreover, the Section 469 Proposed Regulations do not carve out certain rights that state law limited partners typically have held (without jeopardizing their limited liability status), as do the Section 892 Proposed Regulations.

Nevertheless, there are strong similarities between the two sets of Proposed Regulations. Both Preambles state the proposed rules are provided solely for purposes of the particular Code section. The Preamble to the Section 469 Proposed Regulations also states that "no inference is intended that the same rules would apply for any other provisions of the Code requiring a distinction between a general partner and a limited partner"—a disclaimer virtually identical to that contained in the Preamble to the Section 892 Proposed Regulations.

11. Special Rules for LLC Members

This alternative would apply solely to LLC members. As LLC members are not state law limited or general partners, the LLC member would not be treated as a "limited partner" for those Code provisions and Regulations that have operative effect only for "limited partners."⁸³ The default rule would seem to be that every LLC member would have NEFSE on his or her share of LLC income because none of them is a limited partner under state law.⁸⁴ This strict approach is supported by Ltr. Rul. 9432018, which holds that an LLC member is not eligible for the exemption from NEFSE under Section 1402(a)(13), because the member's distributive share of income is not excepted from NEFSE by that section. Similarly, the LLC member would not be treated as a "general partner" for the Code and Regulations sections that have operative effect only for "general partners." This alternative obviously would be simple to administer.

The difficulty with this approach is that it can generate inequitable results, since LLC members should in certain situations be treated for tax purposes in the same fashion as state law limited or general partners. Moreover, for those operative tax provisions where one has certain tax consequences if treated as limited partner and other tax consequences if treated as a general partner, *query* what are the tax consequences where an LLC member (tax partner) is treated as neither a limited nor a general partner. A (second) special rule would have to be implemented to deal with LLC members in that situation.

For at least some purposes of the Code, an LLC member is interpreted as not a "limited partner," under definitions dealing with one's status as a "limited partner or limited entrepreneur." This phrase appears in Sections 464, 1256, and 1258. The operative effect of this approach is to put in the same basket limited partners and members of other LLEs who do not actively participate in management. Thus the exclusion of "passive" LLC members from "limited partner" status does not necessarily cause them to be treated as "general partners" for tax purposes; they still may be subjected (as limited entrepreneurs) to the same operative rules that apply to "limited partners."

This approach also has been adopted under the passive activity Regulations dealing with grouping of activities (Reg. 1.469-4, "Definition of Activity"). An example in that Regulation confirms that a member of an LLC who does not actively participate in the management of the LLC is not a "limited partner" but rather a "limited entrepreneur" for purposes of that Regulation.

Section 464(e)(2) defines a "limited entrepreneur" to be a person who (1) has an interest in an enterprise other than as a limited partner, and (2) does not actively participate in the management of such enterprise. Reg. 1.469-4(d)(3) provides, as a general rule, that a taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in Section 465(c)(1) may not group that activity with another activity in the same type of business (subject to certain exceptions not relevant here).

The Regulation uses a taxpayer's status as a "limited partner or a limited entrepreneur (as defined in Section 464(e)(2))" as its touchstone. In the example in Reg. 1.469-4(d)(3)(ii), an individual (A) is a member of M, an LLC that conducts a cattle-feeding business. A does not actively participate in the management of M (within the meaning of Section 464(e)(2)(B)). In addition, A is a limited partner in N,

a state law limited partnership engaged in oil and gas production. The example states that because A does not actively participate in the management of LLC M, A is a limited entrepreneur in M's activity. The example categorizes A as a state law limited partner in N, however, and treats A as a "limited partner" (not "limited entrepreneur," as he is with respect to his LLC interest). By analogy, this clearly indicates that a member of an LLC who does not actively participate in the management of the LLC will not be treated as a "limited partner" but rather as a "limited entrepreneur" (i.e., having an interest in an enterprise other than as a limited partner) for purposes of Sections 464, 1256, and 1258.

HOW 'LIMITED PARTNER' AND 'GENERAL PARTNER' HAVE BEEN DEFINED

In the preceding portion of this article, we identified numerous ways that Treasury and the IRS or the courts might discern who are "limited partners" and "general partners" under those Code and Regulations provisions that feature either or both terms. In this section we focus on some of the operative Code provisions that use those terms (namely, Sections 469, 736, 1256, 1402 pre-*Renkemeyer*, and 6231), and attempt to identify which methods have been used as well as the partial definitions that have evolved. Our goal is to examine how the tax law characterized members of LLEs (before *Renkemeyer*) as being "general partners" or "limited partners" for purposes of those tax provisions, and which of the nearly 20 approaches and variants we identified in the preceding portion of this article are being used by Treasury, the IRS, and/or the courts.

Passive Activities

Section 469 was added to the Code in 1986, before much of the development of unincorporated LLEs discussed above. It provides that individuals, estates, trusts, closely held C corporations, and personal service corporations may not deduct passive activity losses or passive activity credits in determining their income. Under Section 469(c)(1), a passive activity is an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.

As defined in Section 469(h)(1), "material participation" exists if a taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. Under Section 469(h)(2), unless otherwise 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." Section 469(l)(3) authorizes Regulations that may be "necessary or appropriate to carry out provisions of this section, including regulations... requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity."

In changing the law, the Senate Finance Committee intended to ensure that tax preferences benefited only those individuals and entities that Congress intended to be benefited. Specifically, "[t]he Committee believes that, in order for tax preferences to function as intended, their benefit must be directed primarily to taxpayers with a substantial and *bona fide* involvement in the activities to which the preferences relate. The Committee also believes that it is appropriate to encourage nonparticipating investors to invest in particular activities, by permitting the use of preferences to reduce the rate of tax on income from those activities; however, such investors should not be permitted to use tax benefits to shelter unrelated income."⁸⁵

The Finance Committee did not believe losses from limited partner interests should be available to offset positive income from other sources.⁸⁶ The Senate Report explains that "[l]osses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity."⁸⁷ Special considerations exist for determining what is a passive activity in the case of limited partners because limited partners are often pooled in order to make passive investments. The Finance Committee also assumed—wrongly—that income allocable to a limited partner automatically was passive due to the nature of limited partnerships and the inability of limited partners to participate actively in an activity if they wish to maintain limited liability status.⁸⁸

The Senate Report provides that limited partner interests are conclusively presumed not to involve material participation by the taxpayer unless otherwise provided by Regulations. The basis for that conclusion is that, “[i]n general, under relevant State laws, 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.”⁸⁹

The reason Treasury has the power to specify when limited partner interests will not be treated as passive is to eliminate the possibility that taxpayers will use and manipulate the presumption to circumvent the passive activity rules.⁹⁰ The TRA ’86 Conference Report reiterates that an interest in a limited partnership is treated as an interest in a passive activity because “a limited partner generally is precluded from materially participating in the partnership’s activities....”⁹¹

Temp. Reg. 1.469-5T includes several rules relating to material participation. First, it includes seven tests for determining whether an individual materially participates in an activity. Second, it contains rules for determining whether a limited partner satisfies the material participation test, and it is clearly more difficult for a limited partner to satisfy the material participation test because only three of the seven tests apply in testing limited partners. Third, Temp. Reg. 1.469-5T(e)(3)(i) defines an interest in an entity taxed as a partnership as a “limited partnership interest” if either:

- (1) The interest is designated as a limited partner interest under state law “without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law.”
- (2) The liability of the holder is limited, under the law of the state in which the entity is organized, to a determinable fixed amount (e.g., the sum of the holder’s prior capital contributions and contractual obligations to make additional capital contributions).

Finally, the Temporary Regulations provide that if a person is both a general partner and a limited partner in the same partnership, the limited partner interest will *not* be treated as a limited partner interest for these purposes. In this regard, the Temporary Regulations recognize that if one partner has a general partner interest, the unique rules pertaining to limited partners should not apply and that partner will be tested under the general participation tests.

As noted above, Congress created the material participation and active participation presumptions for limited partner interests because Congress believed the holders of those interests could not participate under state law without losing the cloak of limited liability. That belief was arguably no longer valid in 1986 (when Congress enacted Section 469), particularly with respect to limited partnerships organized in a state that had adopted ULPA (1976). Clearly, the original assumptions regarding participation of limited partners are generally no longer valid today, when almost all states have adopted the 1976, 1985, or 2001 versions of ULPA.

In *Gregg*, the court effectively held that a member of an LLC should be treated as a general partner for purposes of determining under Section 469 whether a loss is from a passive activity. The Service had argued that a member of an LLC should be treated as a limited partner because Temp. Reg. 1.469-5T(e)(3)(i)(B) provides that a partnership interest is treated as a limited partner interest if the liability of the holder for obligations of the partnership is limited to a fixed amount. The court concluded that an LLC cannot be a limited partnership for tax purposes because for state partnership law purposes a limited partnership must have one general partner.⁹² Further, the court noted that LLC members retained their limited liability regardless of their level of participation, whereas a limited partner in a limited partnership cannot participate in management.

The district court did not discuss or distinguish section 70.135 of the Oregon Limited Partnership Statute when it reached this conclusion. That provision allows limited partners to vote, approve, propose, and disapprove of any management decision of the partnership without becoming liable for claims against the partnership so long as the limited partner lets people know it is acting as a limited partner. The court then considered the seven tests for material participation in Temp. Reg. 1.469-5T(a) and determined that the member of the LLC materially participated in the activity. Therefore, the losses were not passive activity losses.

A careful review of the *Gregg* court's analysis and holding reveals that the court did not literally find the LLC member to be a "general partner" for tax purposes, including Section 469. Rather, it held that the higher standard of material participation test for limited partners should not be applied to the plaintiff; thus, the taxpayer could (like a general partner) prove his material participation in the LLC's activity if he could satisfy any one of the seven tests set forth in Temp. Reg. 1.469-5T(a).⁹³

The *Gregg* court may have reached the correct conclusion as a policy matter, but its logic may be difficult to reconcile with other cases. It may have been better for the court to have simply concluded the Temporary Regulations were incorrect and that the members should be tested based on levels of activity under the general partner tests. For example, in *Norwood* the Tax Court concluded that a general partner's share of income of a partnership is subject to SE tax under Section 1402 regardless of how active the partner is in the partnership. It is not clear whether the taxpayers in *Gregg* would have been able to successfully argue they were limited partners when the time came to pay SE taxes on their shares of LLC income, but *Gregg* does raise this and other interesting questions.

The district court's analysis in *Gregg* was rejected by the Tax Court in *Garnett*, but not by the Court of Federal Claims in *Thompson*, 104 AFTR 2d 2009-5381, 87 Fed Cl 728 (Fed. Cl. Ct., 2009). In *Garnett*, the Tax Court rejected the taxpayer's position that he could not own a limited partnership interest in a limited partnership for purposes of Section 469(h)(2) and Temp. Reg. 1.469-5T simply because he was a member of an LLC, which as a matter of state law could not be a limited partnership. Thus, under *Garnett*, one might be deemed a "limited partner" under Section 469 but one was not logically precluded from being a "general partner" for other federal tax purposes.

In contrast, in *Thompson*⁹⁴ (as in *Gregg*), the court agreed that an ownership interest must be in an entity that is a partnership under state law, for the taxpayer to possibly be treated as a "limited partner" for tax purposes under Section 469. Under *Gregg* and *Thompson*, even a member of an LLC who is *not* the LLC's manager will be treated as not owning a limited partnership interest as a limited partner, simply because LLCs are not state law limited partnerships and it logically follows that its members cannot be "limited partners" for tax purposes.

The reasoning in *Gregg*, *Thompson* and *Garnett* is not all consistent. Nevertheless, in each case the court held that an active member of an LLC or LLP was not a "limited partner" under Temp. Reg. 1.469-5T(e). After losing these and other cases in 2009 and 2010, the Service acquiesced in this result in 2010.⁹⁵

It is submitted that members of an LLC and partners of an LLP (all of whom are state law general partners) should not be treated as "limited partners" under Temp. Reg. 1.469-5T(e) simply because of a limitation on their liability for obligations of the entity. The presumption of limited involvement described in the legislative history regarding limited partners does not apply to members of an LLC or LLP. Thus, a test that classifies as general partners those members who may participate and as limited partners those members who will not participate may be consistent with the legislative history, if not entirely logical.

As discussed above, Treasury and the IRS recently issued Proposed Regulations that would classify "limited partners" for purposes of Section 469(h)(2) as those members of a tax partnership who do not have the rights to manage the entity at all times during the entity's tax year under the law of the jurisdiction in which the entity was organized and under the governing agreement. The Preamble to the Section 469

Proposed Regulations states that rights to manage include the power to bind the entity. Thus, having either the *right* to manage or the *power* to bind will result in an individual member of an LLE being deemed a “general partner” (i.e., “not a limited partner”) for purposes of Section 469(h)(2), and thus will maximize the number of partners who can be classified as “general partners” for the more favorable material participation tests in Temp. Reg. 1.469-5T(a).

Why do the new Proposed Regulations and Preamble apparently provide a more expansive definition of “general partner” under Section 469(h)(2) than under other operative Code provisions? One might speculate that the unanimity of the courts (in *Gregg, Garnett, Thompson, and Newell*, TC Memo 2010-23, RIA TC Memo ¶¶2010-023) in finding each LLC member to be a “general partner” for purposes of Section 469(h)(2) has sufficiently impressed Treasury and the IRS to cause them to liberalize the current provision (Temp. Reg. 1.469-5T(e)).

Indeed, the Preamble recites the holdings of those four cases at some length, and expressly recognizes that the “original presumptions” (in 1986) regarding the limitations on a limited partner’s participation in the activities of the entity are no longer valid today. The Preamble also recognizes “the emergence of LLCs.” For these reasons, the Preamble states the Proposed Regulations eliminate the current Regulations’ reliance on limited liability as the keystone for “limited partner” status under Section 469(h) (2). The Preamble further states that the Section 469 Proposed Regulations provide rules concerning an interest in a limited partnership “based on the purposes for which section 469 was enacted, and the manner in which the provision is structured and operates within the Code.” The Preamble cautions that no inference is intended that the same rules would apply for any other provisions of the Code pertaining to distinctions between a “general partner” and a “limited partner.”

Payments to a Retiring Partner or a Deceased Partner’s Successor

Section 736(a) provides that payments made in liquidation of a retiring partner’s or a deceased partner’s interest generally should be considered “as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership” or “as a guaranteed payment described in Section 707(c) if the amount thereof is determined without regard to the income of the partnership.”

Generally, payments made in liquidation of the interest of a retiring partner or a deceased partner are treated as made in exchange for the interest of the partner in partnership property and as a distribution by the partnership, rather than as an allocation of income or a guaranteed payment.⁹⁶ Payments in exchange for an interest in partnership property, however, do not include amounts paid for unrealized receivables or goodwill of the partnership, except to the extent a partnership agreement provides for payment with respect to goodwill.⁹⁷ This exception for unrealized receivables and goodwill applies only if capital is not a material income-producing factor for the partnership, and the retiring or deceased partner was a general partner in the partnership.⁹⁸

In 1993, RRA ’93 section 13262(a) added to Section 736(b) the provision that a payment for unrealized receivables or goodwill will be treated as a distribution unless capital is not a material income-producing factor and the partner is a general partner. The House Report noted that prior law required that a liquidating payment made in exchange for a partner’s interest in partnership property be treated as a distribution by the partnership; amounts paid for goodwill of the partnership and unrealized receivables generally would not be treated as having been paid in exchange for interests in partnership property.⁹⁹

In discussing reasons for this change, the House Report noted that Section 736 was supposed to simplify the taxation of liquidation payments to partners.¹⁰⁰ Instead, the House Report commented that Section 736 is confusing because it is not always clear whether a payment is in liquidation or pursuant to a sale. Thus, Congress sought to reduce this confusion by eliminating the one significant difference between

sales of interests and liquidations.¹⁰¹ Congress also “recognized, however, that general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive this special rule of present law.”¹⁰²

The House Report also discusses when capital is a material income-producing factor,¹⁰³ but there is no discussion in the legislative history regarding the general partner requirement. Nevertheless, the explanation of when capital is a material income-producing factor and the references to businesses receiving compensation for personal services performed by individuals may indicate that the reference in the statute to “general partner” is simply intended to cover persons typically involved in these situations. For example, the RRA '93 Conference Report noted that “[i]n addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.”¹⁰⁴ The Conference Report does not refer to a retiring “general” partner. Further, the rule clearly applies to any general partner, regardless of how active in the business of the partnership.

The best evidence as to the intended recipients of existing Section 736 is presented by the references to those partners who do not ordinarily value goodwill in calculating liquidation payments and to partners of partnerships in which capital is not a material income-producing factor. While actual activity of the partner is not significant, the nature of the partnership’s business *is* significant. Nevertheless, the legislative history does not indicate what other restrictions (if any) should be placed on an LLC member’s ability to be treated as a general partner for this purpose.

Definitions Related to SE Income

Section 1401 imposes Social Security taxes on the SE income of every individual. Section 1402(b) defines SE income as NEFSE less certain adjustments. Section 1402(a) defines NEFSE as the gross income earned by an individual from a trade or business conducted by the individual, less deductions allowed by Subtitle A that are attributable to the trade or business, plus the individual’s distributable share of income or loss described in Section 702(a)(8) from a trade or business carried on by a partnership of which the individual is a member, and as further adjusted for other items described in Section 1402(a).¹⁰⁵

Section 1402(a)(13), however, excludes from NEFSE “the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.”¹⁰⁶

Before 1978, a partner’s share of partnership income from the trade or business was includable in NEFSE without regard to status as a general or limited partner, level of activity, or participation in or (lack of) control of the partnership.¹⁰⁷ The exclusion from NEFSE for income and loss of limited partners was enacted as part of the Social Security Amendments of 1977. The 1977 House Report noted that the House Bill excluded “the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership [from Social Security coverage] ... to exclude for coverage purposes certain earnings which [were] basically of an investment nature.”¹⁰⁸

As the quote from the statute makes clear, however, the exclusion from coverage would not extend to payments such as salary and professional fees received for services actually performed by the limited partner for the partnership. The report states that distributive shares received as a general partner would continue to be subject to Social Security taxes. Also, if a person were both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be subject to tax.¹⁰⁹

The House Report described as a fundamental congressional concern those business organizations that “solicit investments in limited partnerships as a means for an investor to become insured for social security benefits.”¹¹⁰ In these situations, an investor in a limited partnership would not perform any services for the partnership, but would receive Social Security coverage on account of investment income. The House

Report explained that “this situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.”¹¹¹ Essentially, Section 1402(a)(13) was added to the Code to eliminate an unintended tax benefit, i.e., coverage of passive investors under Social Security.

Treasury and the IRS have tried on two occasions to define “limited partner” for purposes of Section 1402, but neither effort has gained traction.¹¹² The first set of rules addressing this issue, Prop. Reg. 1.1402(a)-18, was issued in December 1994.¹¹³ In response to comments, early in 1997 Treasury and the IRS withdrew the 1994 notice of proposed rulemaking and issued Prop. Reg. 1.1402(a)-2.

Generally, an individual would be treated as a “limited partner” under the revised rules unless the individual (1) has personal liability for debts of or claims against the partnership by reason of being a partner, (2) has authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership, or (3) participates in the partnership’s trade or business for more than 500 hours during the partnership’s tax year.¹¹⁴ In addition, rules are included for bifurcating a member’s interest so that the member of an LLC, for example, may be treated as owning both “limited partner” and “general partner” interests in the same LLC. Further, the amendments included various special rules.¹¹⁵

The 1997 Proposed Regulation included a special set of rules for service partners in service partnerships. An individual who is a service partner in a service partnership would not be treated as a “limited partner.”¹¹⁶ A service partner is a partner who provides services to or on behalf of the service partnership’s trade or business, and a service partnership is one substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.¹¹⁷

The proposed amendments were heavily criticized, though not by practitioners.¹¹⁸ Congress, responding to the populist-based criticism, enacted TRA ’97 section 935, which provided that Temporary and final Regulations with respect to the definition of a “limited partner” under Section 1402(a)(13) could not be issued or made effective before 7/1/98. No new guidance has been issued since this moratorium. In July 1999, the American Bar Association submitted a proposal recommending that Congress amend the Code to provide that income of owners of an entity taxable as a partnership (including an LLC), which income is attributable to capital, is not subject to SE taxes.¹¹⁹ In light of the flurry of criticism and debate regarding the Proposed Regulations, it is likely no new administrative action will be taken before the enactment of legislation amending Section 1402(a)(13).

Members of a ‘Syndicate’

Three Code provisions refer to “limited partner or limited entrepreneur” as having operative effect: Sections 464(e)(2), 1256, and 1258. Of the three, only Section 1256 provides any guidance as to the meaning of “limited partner.”

For purposes of Section 1256, a “syndicate” is defined to include any partnership if more than 35% of the losses of that entity are allocable to “limited partners or limited entrepreneurs” (within the meaning of Section 464(e)(2)). For this purpose, if the limited partner or certain relatives “actively participate at all times during such period in the management of such entity,” the interest in the entity is not treated as held by “a limited partner or limited entrepreneur.”¹²⁰ The guidance under Section 1256 pertains solely to the question of when an interest that otherwise would be deemed to be held by a limited partner will not be treated as “held by a limited partner.”¹²¹ Nevertheless, Section 1256 and the Regulations thereunder do not identify who is a “limited partner” in the first place. Thus, they provide no useful guidance as to the meaning of the term or the methodology that should be employed to determine who is a “limited partner” (or “general partner”) for purposes of Section 1256. One might speculate that a “limited partner” is a member of a state law limited partnership and a “limited entrepreneur” is a member of an entity other than a state law limited partnership who does not “actively participate” in similar circumstances.

TEFRA Audit Rules

For purposes of the partnership audit provisions in Sections 6221 through 6233 as added by TEFRA, Section 6231 defines partnerships, partners, partnership items, nonpartnership items, affected items, and computational adjustments. Section 6231(a)(7) defines the TMP as “the general partner designated as a tax matters partner as provided in regulations.” If no general partner is designated as such, the TMP is “the general partner having the largest profits interest in the partnership at the close of the taxable year involved.” Furthermore, when a general partner is not designated as the TMP or Section 6231(b) cannot be applied by IRS, the Service may select a partner to be treated as the TMP.

The TEFRA Conference Report indicates that the focus on “general partners” in Section 6231 is clearly based on the assumption that general partners have authority to bind the partnership, and are most likely to be in a position to provide notice to other partners.¹²²

Reg. 301.6231(a)(7)-2, relating to the designation of TMPs for LLCs classified as partnerships for tax purposes, provides that solely for purposes of application of Section 6231(a)(7) to an LLC, a “member-manager” of an LLC will be treated as a “general partner” and an LLC member who is not a “member-manager” will be treated as a partner who is not a “general partner.”

A “member-manager” is defined as a member of an LLC who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. Generally, an LLC statute may permit the LLC to choose management by one or more managers (whether or not members) or by all of the members. If there are no elected or designated member-managers of the LLC, each member will be treated as a member-manager for purposes of Section 6231.¹²³

The Preamble to Prop. Reg. 301.6231(a)(7)-2, which is substantially the same as the final Regulation, noted that this approach was adopted because those persons should have the necessary authority and access to records needed to act as a TMP. The final Regulations define an LLC as an organization (taxable as a partnership) that is formed under a law that permits limiting the liability of all members for debts and obligations of the entity.¹²⁴

It is submitted that any solution for identifying who may act as the TMP of an LLC should focus on authority to act on behalf of the entity. That person probably has access to the LLC’s records and may give required notices to members. Clearly, members of an LLC should be able to act as a TMP, particularly if they have actual or apparent authority to bind the LLC.¹²⁵

CHARACTERIZATION: COMPREHENSIVE OR SECTION-BY-SECTION APPROACH?

Before the proliferation of LLCs, LLPs, LLLPs, and other LLEs, your author identified an atypical situation where one who initially had a potential limited liability shield (as a state law limited partner) became so active in the partnership’s business and activities as to become liable as a general partner for state partnership law purposes (under ULPA (1916) section 7). To illustrate, let’s assume there is a partnership obligation which the taxpayer (a state law limited partner) wishes to include in his tax basis under Section 752 or amount at risk under Section 465.

Must the state law limited partner be characterized as a “general partner” for all purposes of federal taxation (i.e., a Comprehensive Approach to his tax status), before determining the inclusion of the obligation in his amount at risk under Section 465 or in his basis under Section 752? Or, should there be a determination made with respect to each and every operative tax provision that may arise with respect to this putative state law limited partner? (As we shall see in Part 2 of this article, this question also underlies the Tax Court’s analysis in *Renkemeyer*.)

The Comprehensive Approach would apply a consistent definition to all of the Code provisions and Regulations, while a Section-by-Section Approach would take into account the purposes of each Code provision and fashion a solution (i.e., require a general-or-limited partner characterization) for each such section. We are not aware of any tax case that squarely faced the issue in the context of ULPA (1916) section 7 (or its successor provisions in subsequent uniform limited partnership acts.)¹²⁶

Nevertheless, some support for treating the violative limited partner as being a “general partner” for all purposes of federal taxation can be found in dictum in two dated tax cases. In *Filesi*, 16 AFTR 2d 6271, 352 F2d 339 (CA-4, 1965), the Fourth Circuit described the determination by the lower court that one’s liability for taking an active part in management and control of the business under ULPA (1916) section 7 made him “a general partner.” Similarly, in *Glensder Textile Co.*, 46 BTA 176 (1942), *acq.*, the court stated in dictum that the moment a limited partner enters into a business activity he “would lose his status as a limited partner and become a general partner.”

These two tax cases apparently would support the premise that a limited partner who is liable as a general partner becomes a “general partner” for all tax purposes. Neither court, however, examined the issue of whether the operative Code sections depended on the categorization of the purported limited partner, and thus are not strong authority.¹²⁷

The uncertainty of these decades-old cases mirrors the uncertainty of whether a limited partner who participated in control of the business remains one for nontax purposes, or whether he becomes a state law general partner. The better view appears to be that the limited partner continues in his status as a limited partner, and retains his rights and powers as a limited partner notwithstanding his liability as a general partner under ULPA (1916) section 7.¹²⁸ Moreover, under ULPA (1976) section 303(a) and subsequent uniform acts and amendments, it seems clear that a limited partner who takes part in control of the business nonetheless remains a limited partner (despite potential or actual liability for certain partnership obligations).

The question of whether a Comprehensive Approach or a Section-by-Section Approach would be applied in the context of a state law limited partner being characterized as a general partner for (at least certain) federal tax purposes arose in *Pritchett*, 85 TC 580 (1985), a reviewed decision. There, a limited partner made himself personally liable in a capacity analogous to that of a general partner with respect to a particular partnership obligation (by agreeing to make capital contributions to the partnership to cover any deficiency in the note’s payment by the partnership at maturity, although as a state law limited partner he was not obligated to do so).

The Tax Court analyzed whether the partner’s obligation increased his at-risk basis under Section 465 in years before he would be called on to make good on his contribution obligation. Judge Whitaker’s dissenting opinion, joined by four colleagues, noted your author’s suggestion “that the courts should not attempt to pigeonhole a limited partner who is liable as a general partner into one category [i.e., “limited partner” or “general partner”] for *all* purposes of taxation, rather, they should determine the underlying congressional policy of the operative Code provision and make a de facto analysis on a case-by-case basis.”¹²⁹

More recently, in the 1996 Special Report, the authors suggested an overall approach that would focus on certain state law characteristics in fashioning an overall solution that would apply universally to all Code sections. Although this approach was endorsed by the ABA’s Section of Taxation for adoption by Treasury and the IRS, a broad-based approach to date has not gained traction.

In the meantime, however, with respect to state law limited partnerships, it appears that Treasury and the IRS are applying a Section-by-Section Approach.¹³⁰ In at least one instance (Prop. Reg. 1.1402(a)-2, discussed earlier), an attempt at administrative guidance was subjected to unwanted (and, in our

view, unwarranted) congressional attention (and interference?) in a manner that makes it less likely that Treasury and the IRS will venture far to fashion further solutions under Section 1402(a)(13), particularly so in the near future.

CLASSIFYING MEMBERS OF STATE LAW LIMITED PARTNERSHIPS

As discussed above, it was fairly well established (before *Renkemeyer*) that for purposes of Section 1402(a)(13), the determination of whether one is a “limited partner” was made solely under state partnership law. If the partner was a limited partner for state law purposes, he was a “limited partner” under Section 1402(a)(13) even if he was active in the partnership’s business operations. If he was not a limited partner under state partnership law, it did not matter how passive he was—he was still not a “limited partner” for purposes of Section 1402(a)(13).

As noted above, and as will be discussed in detail in Part 2, *Renkemeyer* has cast doubt on the applicability of the State Law Characterization Approach, at least for purposes of Section 1402(a)(13). In turn, this raises a concern that, under the rationale employed in *Renkemeyer*, state law limited partners who provide services without losing limited liability could nonetheless be treated as not being “limited partners” for NEFSE purposes.

CLASSIFYING MEMBERS OF LLLPs

We next consider characterization of members of an LLLP. For state law purposes, the LLLP is a limited partnership, having one or more general partners and one or more limited partners. Pursuant to the special limited liability rules contained in the LLLP’s statutory provisions, the liability of all partners in an LLLP for debts and obligations of the entity is limited, and partners (including general partners) are not liable for the entity’s debts and obligations solely by reason of being partners.

Management authority vests in the general partners, however, as is true of a state law limited partnership. Thus, if state law characterization controls, the LLLP’s general partners should be treated as such for tax purposes and conversely its limited partners should be treated for tax purposes as “limited partners.”

CLASSIFYING MEMBERS OF LLCs

The Section-by-Section Approach and the Comprehensive Approach are the two principal methods of classifying members of LLCs as “limited partners” or “general partners.” The Round Hole article 131 discussed two principal alternatives for classifying members of LLCs under all relevant Code sections:

- A Section-by-Section Approach focusing on the goals and purposes of each instance where the distinction is relevant.
- An overall single definition for “limited partner” and a single definition for “general partner.”

The Round Hole article observed that either approach is difficult because sections of the Code that refer to “general partners” and “limited partners” address specific goals and purposes when referring to either class of partners. In several instances, Code provisions seem to rely on the general distinctions between classes of partners in pre-1985 ULPA law, which is no longer in effect in most states.

Significantly, because much of LLC law is derived from recent state law limited partnership statutes, many of the rights, duties, and obligations of members of LLCs are actually very similar to those rights, duties, and obligations of partners in ULPA partnerships. LLC statutes simply offer LLC members greater flexibility in how these rights, duties, and obligations are assigned to or divided among the members. If one focuses on these characteristics of ownership, several methods become apparent for characterizing LLC members as “general partners” and “limited partners” for federal tax purposes.

LLCs: Miscellaneous Issues

Unfortunately, identifying the proper test or tests for characterizing persons as general partners or limited partners is not the only unresolved issue. Other issues are raised by the alternatives for distinguishing between “general partners” and “limited partners.” Although discussion of many of these issues is beyond the scope of this article, a partial listing may be helpful. For example, in the context of an LLC:

- (1) How should changes in interests during the year be treated? If an LLC elects managers annually, should any person who is a manager at any time during the majority of days during the year be treated as a manager for the entire year for this purpose? For administrative ease, might manager status be tested as of the first or last day of the LLC’s tax year?
- (2) If the applicable test is the presence or absence of authority, what happens if a member has the requisite apparent authority and then delegates this authority to other persons? What if the delegate is or is not another member of the LLC? What if the member delegates only a portion of the authority? Presumably, the results should be the same as under current law for “general partners,” so that delegation should not change that member’s status.
- (3) Can interests be bifurcated such that a person who is a manager and who owns a membership interest be treated as both a “general partner” and a “limited partner”? Under partnership law, interests clearly may be bifurcated. Under most LLC statutes, however, bifurcation is more difficult: Either the LLC is member-managed or manager-managed. In a manager-managed LLC, management rights are separate from ownership interests; indeed, the manager need not even be an owner of the entity. In a member-managed entity, however, the management rights and apparent authority are inherent in the interests of the members, which in that regard is akin to a general partnership.
- (4) How should these tests be applied to LLCs that have different businesses? As one alternative, a tracing approach might be adopted under which income from separate activities would be traced to the members, who would be characterized as limited or general partners for tax purposes with respect to each activity. The benefits of accuracy for members of an LLC that conducts multiple activities must be balanced against the difficulty of administering a tracing approach.
- (5) If a solution can be devised for LLCs, exactly how should LLCs be defined? The 1997 Proposed Regulation issued under Section 1402 and the final Regulations under Section 6231 define an LLC as an entity formed under a law that allows the limitation of the liability of all members for the organization. That definition also encompasses LLPs, LLLPs, and certain business trusts. It may be more appropriate to use a broader concept of unincorporated entity—the LLE—and include therein any entity (including LLCs, LLPs, and LLLPs) that permits the limitation of the liability of all of its members.

LLCs: Second-Generation Entities

Now consider a second-generation LLE (i.e., a manager-managed LLC that conducts a personal service business). Assume A, B, C, and D, who are the partners of general partnership ABCD, decide to convert their general partnership into an LLC in which A and B are the managers (ABCD-LLC). A, B, and C devote extensive time to the business; D currently devotes no time to the business.

Section-by-Section Approach. If the Section-by-Section Approach applies, the tax characterization of the LLC members may be determined as follows.

None of the members is liable for debts and obligations of the LLC solely by reason of being members. Under Temp. Reg. 1.469-5T, each member of an LLC is treated as a “limited partner” and tested accordingly for purposes of the passive loss rules. The “correct” answer, however, should be that A, B, C, and D all

would be treated as “general partners,” for reasons described above, and tested under the seven tests for material participation in Temp. Reg. 1.469-5T(a). The courts in *Garnett* and *Thompson*, decided 20 days apart, rejected the Service’s attempt to treat both the members of LLCs and the partners in LLPs as “limited partners” for purposes of the passive loss rules.

While there is no guidance under Section 736, it appears that the critical factors are the nature of the partnership and whether the partners ordinarily would value goodwill in calculating liquidation payments. Because the business is basically a service partnership in which capital is not a material income-producing factor, it appears that all four members of ABCD-LLC should qualify as “general partners” for purposes of Section 736. The relative inactivity of C and D should not affect their status as “general partners” for these purposes.

Under Prop. Reg. 1.1402(a)-2, A and B would be treated as “general partners” for purposes of Section 1402 because of their apparent authority to bind the LLC. While C does not have apparent authority to bind the LLC, C would be treated as a “general partner” because of the extensive time he devotes to the business of the LLC. If there is a special rule (such as the one in the Proposed Regulations) for service partnerships, D also may be a “general partner” because of the nature of the LLC’s business, although D otherwise would not be characterized as a “general partner” because she lacks authority to bind and currently does not devote any time to working in the business of the LLC.

Section 6231 and the Regulations thereunder focus on authority to bind, and A and B each should qualify to be the TMP of ABCD-LLC, being akin to a general partner in a limited partnership, while C and D should not qualify, being more like limited partners.

Comprehensive Approach. If a Comprehensive Approach to tax characterization were to apply to the members of ABCD-LLC, what is the “correct” test? Should taxpayers, the IRS, and the courts look to activity, management rights, authority, or some combination of these factors (as in Prop. Reg. 1.1402(a)-2)? The test selected would dictate the outcome:

- If apparent authority is the proper standard, only A and B would be “general partners” for all purposes of the Code and Regulations.
- A member’s personal liability for debts and obligations is probably the least appropriate characteristic, whether as an overall approach by itself or as an element of a broader overall approach that incorporates several factors. If liability were the litmus test, all four members of ABCD-LLC would be deemed “limited partners.”
- Although the member’s level of activity may be the “correct” theoretical approach, this factor is difficult to apply in many situations. Would C be a “general partner” if he is “full-time active”? What if C were only “part-time active”? Would D be deemed a “limited partner” for the current tax year (due to her lack of activity on ABCD-LLC matters)? If so, could her (“limited partner” or “general partner”) status change from year to year if she became sufficiently active next year, but not the year after?

Not applying a Comprehensive Approach results in answers that are consistent with a Section-by-Section Approach that applies different tests under each relevant provision.

In summary, both the Comprehensive and the Section-by-Section Approaches to classifying members of LLCs have their advantages and disadvantages. Is there a discernable trend as to whether the IRS or courts are applying one approach or the other to characterize members of LLCs for tax purposes? The Section-by-Section Approach seems to have the upper hand.

CLASSIFYING MEMBERS OF LLPs

Now consider the classification of members of an LLP. Unlike second-generation LLEs, each partner in an LLP is a general partner for state law purposes. In every other respect, however, an LLP is very similar to one of the second generation LLEs—the member-managed LLC. With respect to agency, each member of an LLP has, except as noted below, apparent authority to bind the entity. Like a member-managed LLC, the liability of partners in an LLP for debts and obligations of the entity is limited, and partners are not liable for debts and obligations of the entity solely by reason of being partners. Finally, as in a member-managed LLC, the statutory default rule is that each member of an LLP has equal rights in management. Thus, except for those instances where tax characterization would turn on state law labels, members of an LLP arguably should be characterized for tax purposes the same as members of a second generation member-managed LLC, whether the tests focus on agency, management, liability, or extent of activity.

The agency analysis of an LLP, however, is not that simple. Under RUPA, an LLP may file a statement of limitation which, except for transfers of real estate, has no impact on apparent authority. A partner described in the statement of limitation still has apparent authority to bind in the ordinary course of partnership business (unless a third party has knowledge or notice of the limitation). For real estate, however, the statement of limitation limits a partner’s actual and apparent authority to bind.

Nevertheless, a statement of limitation does not eliminate all of a partner’s apparent authority. For example, the partner still has apparent authority to enter into other contracts in the ordinary course, such as employment contracts or contracts for the purchase of personalty. Thus, the analysis of agency for purposes of classifying a partner of an LLP for tax purposes is not a simple task. (The same is true of a member-managed LLC, where (at least under section 302(g) of ULLCA (2006)) the LLC may limit the actual and apparent authority of a member and manager to transfer real estate.) As such, the alternatives for analyzing application of the various Code sections for an LLP should be the same as the tests for analyzing the characterization of members of a second-generation member-managed LLC.

CONCLUSION

Part 1 of this article has described the uncertainties as to the meaning of “limited partner” and “general partner” in numerous provisions of the Code and Regulations that give operative effect to these terms. We have identified almost 20 approaches to defining them, and raised various issues for consideration in identifying the optimal definitions—particularly in light of the evolution of LLEs and the limited liability protections and levels of activity that members can undertake without loss of the liability shield (unlike the classic state law limited partnership under ULPA (1916)).

Part 2 will focus on the Tax Court’s opinion in *Renkemeyer*, and discuss whether the court’s method of analysis can or should have widespread application beyond the facts in that case. The court’s analytical approach may foreshadow how it (and other courts) will characterize members of LLEs for purposes of the dozen Code and 70-plus Regulations provisions that yield different tax consequences for “general partners” and “limited partners.” Part 2 also will analyze the two sets of Proposed Regulations issued in November 2011, with respect to their definitions of “general partner” and “limited partner” for purposes of Sections 469 and 892; these proposals might be a response to the court’s reasoning in *Renkemeyer* and may signal a sea change in the government’s approach to the meaning of these terms.

Exhibit 1. The ‘General Partner’ and ‘Limited Partner’ Timeline

1. 1914: Uniform Partnership Act (dealing with state partnership law aspects of general partnerships) is promulgated (UPA (1914)). “General partner” is implicitly defined as one of the two or more persons who associate to carry on as co-owners a business for profit.

- 2. 1916:** Uniform Limited Partnership Act (dealing with state partnership law aspects of limited partnerships) is promulgated (ULPA (1916)). “General partner” and “limited partner” are not expressly defined. ULPA (1916) indirectly defines the limited partner’s rights, duties, and obligations.
- 3. 1918:** IRS issues first ruling (second overall) on tax classification of (N.Y.) state limited partnership; treated as a partnership for tax purposes. Limited partners implicitly may be treated as tax partners.¹
- 4. 1938:** First(?) reference to the tax treatment of limited partners appears in a tax case.² At this time only 20 states have adopted ULPA (1916).³
- 5. 1939:** Internal Revenue Code of 1939 is adopted; contains no references to “limited partner” or “general partner.”
- 6. 1954:** Internal Revenue Code of 1954 is adopted; contains no references to “limited partner” or “general partner.”
- 7. 1954:** By this time, 34 of 48 states have adopted ULPA (1916). The common law or statutes in the remaining 14 jurisdictions typically varies in significant ways.⁴
- 8. 1956:** Early Regulations issued under Section 752 describe computations of allocable shares of partnership liabilities among limited and general partners (Reg. 1.752-1(e)); still no definitions of “limited partners” or “general partners” provided in the Code (which does not use these terms), legislative history, relevant Regulations, or Rulings.
- 9. 1958:** Congress enacts obscure provision (Section 512(b)(13)) which provides favorable unrelated business income treatment for “limited partners,” but not for “general partners” or “limited partners liable as general partners.” Neither the statute nor the legislative history define these terms.
- 10. 1976:** ULPA (1916) is revised, among other changes expanding the activities limited partners can undertake without loss of limited liability protection (ULPA (1976)).
- 11. 1976:** First significant usage of “limited partner” appears in the Code (i.e., the farm syndicate rules in Section 464). No definitions of “limited partner” provided in the statute, legislative history, or subsequent Regulations or Rulings.
- 12. 1976:** First domestic LLC Act is adopted in Wyoming (use of LLCs does not become widespread until IRS rules on the LLC’s tax status as a partnership, 12 years later).
- 13. 1977:** Congress enacts Section 1402(a)(12) (now Section 1402(a)(13)) to provide a “limited partner” exception from net earnings from self-employment (NEFSE). No definition of “limited partner” in the statute or legislative history.
- 14. 1978:** First significant usage of “general partner” appears in the Code (in the initial partnership statute of limitations provisions in Section 6501(q)(3)(A) (since repealed)). No definition of “general partner” in the statute, legislative history, or subsequent Regulations or Rulings.
- 15. 1979:** Tax Law Review publishes article on tax distinctions between limited and general partners; it is the first article to attempt to deal comprehensively with definitional uncertainties of “limited partner” and “general partner” for tax purposes.⁵
- 16. 1982:** Congress identifies which “general partner” is the TMP for tax purposes of the TEFRA partnership rules under Section 6231(c)(7).
- 17. 1984:** Congress enacts Section 1256(e)(3)(B), which refers to certain “limited partners or limited entrepreneurs” for purposes of the rules pertaining to Section 1256 contracts; an interest in an entity will

not be treated as held by a “limited partner” if, inter alia, the holder of the interest actively participates in the management of the entity under Section 1256(e)(3)(C). Also, special rules under Section 1256(f)(4) pertaining to dealer equity options and dealer securities futures contracts apply to certain “limited partners” (within the meaning of Section 1256(e)(3)).

18. 1984: Congress enacts Section 465(c)(7)(D)(ii) to provide a qualified corporate partner exception for an active trade or business under the at-risk rules; the exception applies only to a corporate “general partner.” No definition of “general partner” in the statute, legislative history, or subsequent Regulations or Rulings.

19. 1984: For purposes of a transitional rule for certain transfers made before 1985 of property described in Section 707(a)(2)(B)(i), section 73(b) of P.L. 98-369 refers to the transferor being “the sole general partner of the partnership.” No definition of “general partner” in the statute or legislative history.

20. 1984: For purposes of a transitional rule under Section 1031 for like-kind exchanges of partnership interests, section 77(b)(5) of P.L. 98-369 refers to certain exchanges of “an interest as general partner.” No definition of “general partner” in the statute or legislative history.

21. 1985: ULPA (1976) is further revised, among other things to further expand the activities limited partners can undertake without loss of limited liability protection (ULPA (1985)).

22. 1986: Code expands references to “general partners” and “limited partners” in the passive activity limitations provisions in Section 469.

23. 1986: By this time, almost every state has adopted either ULPA (1916) or ULPA (1976).

24. 1988: The Code refers to “the interest of a general partner” in Section 988(c)(1)(E)(v)(I) for purpose of rules identifying owners of funds eligible for special treatment of certain foreign currency transactions, and Section 988(c)(1)(E)(v)(II) refers to income allocated to a “general partner” as incentive compensation. No definition of “general partner” in the statute, legislative history, or subsequent Regulations or Rulings.

25. 1988: IRS rules that LLCs formed and operated under the Wyoming LLC Act are taxable as a partnership under then-applicable tax classification Regulations, followed by numerous private letter rulings of a similar nature for other states’ LLCs, leading to widespread usage of LLCs.

26. 1988: Regulations define a “limited partnership interest” for purposes of Section 469(h)(2) (Temp. Reg. 1.469-5T(e)(3)(i)).

27. 1990: For purposes of the special valuation rules under Section 2701, the definition of “control” in Section 2701(b)(2)(B)(ii) includes “in the case of a limited partnership, the holding of any interest as a general partner.” No definitions provided in the statute, legislative history, or subsequent Regulations or Rulings.

28. 1991: LLPs, a new form of LLE, are first enacted by states; LLPs quickly come into vogue, especially for professional service firms.

29. 1992: In a rule identifying employers that are subject to coal industry health benefit rules under Section 9701, a related-party exception is provided for certain “limited partners.” No definition of “limited partner” in the statute, legislative history, Regulations or Rulings.

30. 1992: Uniform Partnership Act is revised for the first time since 1914 (RUPA (1992)).

31. 1993: In a rule identifying service partners eligible for exchange treatment of payments for goodwill on retirement or death, the Code refers to “general partners” in Section 736(b)(3). No definition of “general partner” in the statute, legislative history, or subsequent Regulations or Rulings.

- 32. 1993:** For purposes of rules pertaining to the recharacterization of gain from certain financial transactions, Section 1258(d)(5)(C) refers to “limited partner or limited entrepreneur” (within the meaning of Section 464(e)(2), described above in item 11).
- 33. 1994:** Treasury and the IRS issue Prop. Reg. 1.1402(a)-18 on the classification of LLC members as “limited partners” or “general partners,” solely for purposes of Section 1402(a)(13). Substantive criticism from professional tax groups and tax practitioners follows.
- 34. 1995:** Check-the-box Regulations are adopted and pave the way for LLEs to be taxed as partnerships, thereby accelerating widespread usage of LLEs.
- 35. 1995:** Three members of the ABA Section of Taxation’s Task Force on Limited Liability Companies submit a letter (“1995 Letter”) to Treasury and the IRS, which includes a suggested Proposed Regulation defining “limited partner” and “general partner” for tax purposes; the proposal uses a “Comprehensive Approach with Specified Exceptions.”⁶
- 36. 1996:** Reg. 301.6231(a)(7)-2(b) provides that solely for purposes of applying the TMP rules of Section 6231(a)(7) (see item 16, above), only a member-manager of an LLC “is treated as a general partner.”
- 37. 1996:** The full ABA Section of Taxation’s Task Force on Limited Liability Companies reviews and endorses the Comprehensive Approach with Specified Exceptions taken in the 1995 Letter, with minor modifications. These comments (the “1996 ABA Comments”) are submitted by the Chair of the ABA Section of Taxation to the Commissioner of Internal Revenue.⁷ (To date, no action has been taken by Treasury or the IRS on the 1995 Letter or the 1996 ABA Comments.)
- 38. 1996:** Uniform Partnership Act is further amended to provide for LLPs, a new form of general partnership (RUPA (1996)). By 1996, over 40 states already had added LLP provisions to their general partnership statutes.
- 39. 1997:** Treasury and the IRS withdraw Prop. Reg. 1.1402(a)-18 and issue Prop. Reg. 1.1402(a)-2 on the classification of members of LLEs as “limited partners” or “general partners,” solely for purposes of Section 1402(a)(13). Substantive comments from professional tax groups and tax practitioners are lukewarm,⁸ but public/political outcry is heard in Washington.
- 40. 1997:** Congress imposes a temporary moratorium on finalization of Prop. Reg. 1.1402(a)-2 and effectively freezes the Regulations project. A related “Sense of the Senate” resolution calls for the Proposed Regulations to be withdrawn.
- 41. 1997:** Congress refers to “limited partners” in the simplified flow-through rules for electing large partnerships in Section 772(f). No definition of “limited partner” in the statute, legislative history, or subsequent Regulations or Rulings.
- 42. 1997:** Uniform Partnership Act pertaining to “general partners” is revised again (RUPA (1997)).
- 43. 1998:** Congressional-imposed moratorium on Prop. Reg. 1.1402(a)-2 expires. Treasury and the IRS neither finalize nor withdraw Prop. Reg. 1.1402(a)-2 ; their informal response is to leave the Proposed Regulations in limbo and await congressional clarification. (Limbo remains the status today.)
- 44. 1999:** ABA’s Section of Taxation (working closely with AICPA’s Tax Division) submits proposal recommending Congress amend Section 1402 to provide that income of owners of tax partnerships (including LLCs) that is attributable to capital not be subjected to SE taxes.⁹ Status as “limited partner” or “general partner” would thereby be moot. (Congress to date has taken no action on this proposal, thereby leaving tax distinctions between “limited partners” and “general partners” intact under Section 1402(a)(13).)

45. 2000: In *Gregg*, 87 AFTR 2d 2001-337, 186 F Supp 2d 1123 (DC Ore., 2000), the court concludes for purposes of Section 469 that an LLC member cannot be a “limited partner” by effectively using a “State Law Characterization Approach.”

46. 2001: ULPA is further revised, among other things to further liberalize actions a limited partner can undertake without loss of limited liability protection (ULPA (2001)).

47. 2001: The Staff of the Joint Committee on Taxation issues a Tax Simplification Report containing a broad analysis of various provisions that refer to a “general partner” or “limited partner.” The report recommends that the determinative factor be whether a partner’s “participation in the management or activity of the partnership is limited under State law (or ... not limited).” (Due to policy implications relating to the determination under Section 1402(a)(13), the Joint Committee excludes this provision from its analysis.)

48. 2009: In *Garnett*, 132 TC 368 (2009), the Tax Court concludes that for purposes of Section 469 an LLC member cannot be a “limited partner,” but rejects the “State Law Characterization Approach.” Also, in *Thompson*, 104 AFTR 2d 2009-5381, 87 Fed Cl 728 (Fed. Cl. Ct., 2009), the court concludes that an LLC member cannot be a “limited partner” for purposes of Section 469, and effectively applies the “State Law Characterization Approach.”

49. 2011: In *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011), the Tax Court concludes that for purposes of Section 1402(a)(13) an LLP member is not a “limited partner” if he renders services for the partnership and earnings on his investment are not the source of his income from the partnership. The court effectively applies the “Section-by-Section Approach” and determines congressional intent with respect to Section 1402(a)(13) by reference to the legislative history.

50. 2011: In new Proposed Regulations (November 2011) under Sections 892 and 469(h)(2), Treasury and the IRS distinguish “limited partner” from “not a limited partner” based on the presence or absence of “the right to manage” the entity; no meaningful elaboration on that standard is provided in the Proposed Regulations or their Preambles.

Exhibit 2. Limitations on Limited Partners’ Activities

Limited partners who are “too” active may face unlimited liability for partnership debts pursuant to the Uniform Limited Partnership Acts, as approved by the National Conference of Commissioners on Uniform State Laws. What follows is a summary of various provisions illustrating the evolution of this principle.

1. ULPA (1916) section 7—Limited partner not liable to creditors—when:

[A] limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in control of the business.

2. ULPA (1976) section 303—Liability to third parties:

(a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. However, if the limited partner’s participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:

- (1) being a contractor for or an agent or employee of the limited partnership or of a general partner;
- (2) consulting with and advising a general partner with respect to the business of the limited partnership;
- (3) acting as surety for the limited partnership;
- (4) approving or disapproving an amendment to the partnership agreement; or
- (5) voting on one or more of the following matters:
 - (i) the dissolution and winding up of the limited partnership;
 - (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business;
 - (iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
 - (iv) a change in the nature of the business; or
 - (v) the removal of a general partner.

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him in the business of the limited partnership.

(d) A limited partner who knowingly permits his name to be used in the name of the limited partnership, except under circumstances permitted by [ULPA section] 102(2), is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

3. ULPA (1976) with 1985 Amendments, section 303—Liability to third parties:

(a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable 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.

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:

- (1) being a contractor for or an agent or employee of the limited partnership or of a general partner or being an officer, director, or shareholder of a general partner that is a corporation;
- (2) consulting with and advising a general partner with respect to the business of the limited partnership;
- (3) acting as surety for the limited partnership or guaranteeing or assuming one or more specific obligations of the limited partnership;
- (4) taking any action required or permitted by law to bring or pursue a derivative action in the right of the limited partnership;
- (5) requesting or attending a meeting of partners;
- (6) proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters:
 - (i) the dissolution and winding up of the limited partnership;

- (ii) the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership;
 - (iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
 - (iv) a change in the nature of the business;
 - (v) the admission or removal of a general partner;
 - (vi) the admission or removal of a limited partner;
 - (vii) a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;
 - (viii) an amendment to the partnership agreement or certificate of limited partnership; or
 - (ix) matters related to the business of the limited partnership not otherwise enumerated in this subsection (b), which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners;
- (7) winding up the limited partnership pursuant to [ULPA] Section 803; or
- (8) exercising any right or power permitted to limited partners under this [Act] and not specifically enumerated in this subsection (b).

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him [or her] in the business of the limited partnership.

(d) A limited partner who knowingly permits his [or her] name to be used in the name of the limited partnership, except under circumstances permitted by [ULPA] Section 102(2), is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

4. ULPA (1976) with 1985 Amendments, section 303—Comments:

Section 303 makes several important changes in Section 7 of the 1916 Act. The first sentence of Section 303(a) differs from the text of Section 7 of the 1916 Act in that it speaks of participating (rather than taking part) in the control of the business; this was done for the sake of consistency with the second sentence of Section 303(a), not to change the meaning of the text. It is intended that judicial decisions interpreting the phrase “takes part in the control of the business” under the prior uniform law will remain applicable to the extent that a different result is not called for by other provisions of Section 303 and other provisions of the Act. The second sentence of Section 303(a) reflects a wholly new concept in the 1976 Act that has been further modified in the 1985 Act. It was adopted partly because of the difficulty of determining when the “control” line has been overstepped, but also (and more importantly) because of a determination that it is not sound public policy to hold a limited partner who is not also a general partner liable for the obligations of the partnership except to persons who have done business with the limited partnership reasonably believing, based on the limited partner’s conduct, that he is a general partner. Paragraph (b) is intended to provide a “safe harbor” by enumerating certain activities which a limited partner may carry on for the partnership without being deemed to have taken part in control of the business. This “safe harbor” list has been expanded beyond that set out in the 1976 Act to reflect case law and statutory developments and more clearly to assure that limited partners are not subjected to general liability where such liability is inappropriate. Paragraph (d) is derived from Section 5 of the 1916 Act, but adds as a condition to the limited partner’s liability the requirement that a limited partner must have knowingly permitted his name to be used in the name of the limited partnership.

5. ULPA (2001), section 303—No Liability as Limited Partner for Limited Partnership Obligations:

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.

6. ULPA (2001), section 303—Comments:

This section provides a full, status-based liability shield for each limited partner, “even if the limited partner participates in the management and control of the limited partnership.” The section thus eliminates the so-called “control rule” with respect to personal liability for entity obligations and brings limited partners into parity with LLC members, LLP partners and corporate shareholders.

The “control rule” first appeared in a uniform act in 1916, although the concept is much older. Section 7 of the original Uniform Limited Partnership Act provided that “A limited partner shall not become liable as a general partner [i.e., for the obligations of the limited partnership] unless ... he takes part in the control of the business.” The 1976 Uniform Limited Partnership Act (ULPA-1976) “carrie[d] over the basic test from former Section 7,” but recognized “the difficulty of determining when the ‘control’ line has been overstepped.” Comment to ULPA-1976, Section 303. Accordingly, ULPA-1976 tried to buttress the limited partner’s shield by (i) providing a safe harbor for a lengthy list of activities deemed not to constitute participating in control, ULPA-1976, Section 303(b), and (ii) limiting a limited partner’s “control rule” liability “only to persons who transact business with the limited partnership with actual knowledge of [the limited partner’s] participation in control.” ULPA-1976, Section 303(a). However, these protections were complicated by a countervailing rule which made a limited partner generally liable for the limited partnership’s obligations “if the limited partner’s participation in the control of the business is ... substantially the same as the exercise of the powers of a general partner.” ULPA-1976, Section 303(a).

The 1985 amendments to ULPA-1976 further buttressed the limited partner’s shield, removing the “substantially the same” rule, expanding the list of safe harbor activities and limiting “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.”

In a world with LLPs, LLCs and, most importantly, LLLPs, the control rule has become an anachronism. This Act therefore takes the next logical step in the evolution of the limited partner’s liability shield and renders the control rule extinct.

The shield established by this section protects only against liability for the limited partnership’s obligations and only to the extent that the limited partner is claimed to be liable on account of being a limited partner. Thus, a person that is both a general and limited partner will be liable as a general partner for the limited partnership’s obligations. Moreover, this section does not prevent a limited partner from being liable as a result of the limited partner’s own conduct and is therefore inapplicable when a third party asserts that a limited partner’s own wrongful conduct has injured the third party. This section is likewise inapplicable to claims by the limited partnership or another partner that a limited partner has breached a duty under this Act or the partnership agreement....

The shield provided by this section applies whether or not a limited partnership is a limited liability limited partnership.

-
1. See, e.g., Banoff, “Tax Distinctions Between Limited and General Partners: An Operational Approach,” 35 Tax L. Rev. 1 (Fall 1979) (the “Tax Distinctions article”), and articles cited in note 14, *infra*.
 2. References herein to “state law” are to domestic entities only (e.g., state partnership law as determined under state statutes for the organization and operation of partnerships), and for simplicity’s sake include entities formed in the District of Columbia. References to state statutes or uniform acts adopted by the National Conference of Commissioners on

Uniform State Laws (NCCUSL) are so identified herein. It is recognized that one may own more than one type of interest in an LLE for state law purposes, e.g., as a limited partner and a general partner. References to “state law” do not refer to state tax law, i.e., the tax law applied by states to characterize owners of LLEs for tax purposes or for determining those owners’ state income tax liabilities.

References to “limited partner(s)”, “general partner(s)”, and “limited” and “general” partners, when so designated in quotation marks, means those tax partners who are treated as such for federal tax purposes (regardless of their status for state law purposes). It is recognized that for federal tax purposes, one may hold interests as a “limited partner” and a “general partner” in the same tax partnership.

3 ULPA (1916), sections 7, 4, and 5, respectively.

4 Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination With the “Patient Protection and Affordable Care Act”* (JCX 18-10, 3/21/10), page 135.

5 New York State Bar Association Tax Section, Report 1247, “Comments on the Application of Employment Taxes to Partners and on the Interaction of the Section 1401 Tax With the New Section 1411 Tax” (the “2011 NYSBA Report”). See Letter dated 11/14/11 from Jodi Schwartz, Chair, NYSBA Tax Section, reprinted at “NYSBA Tax Section Submits Report on Application of Employment Taxes to Partners,” 2011 TNT 220-21 (11/14/11).

6 References herein to a partner’s allocable share of partnership income generally include the allocable share of partnership losses as well, unless the context clearly requires the contrary.

7 See Letter from Patricia A. Thompson, Chair, AICPA Tax Division, transmitting “AICPA Tax Division Comments on the 2011-2012 Guidance Priority List (Notice 2011-39), June 1, 2011,” reprinted at “AICPA Responds to Request for Guidance Priority List Topics,” 2011 TNT 107-24 (6/1/11).

8 The Service addressed the tax classification of a Missouri business trust (another form of unincorporated organization used to conduct business activities) in Rev. Rul. 88-79, 1988-2 CB 361, and concluded that the trust would be taxed as a partnership. Several states have enacted statutes governing business trusts.

The Delaware statutory trust law illustrates the evolution of statutory business trusts. The statute adopts certain aspects of corporate law and the flexibility of partnership law. For example, section 3803 of the Delaware Statutory Trust Act states that “except to the extent otherwise provided in the governing instrument of the statutory trust, the beneficial owners shall be entitled to the same limitation of personal liability extended to stockholders of private corporations for profit organized under the general corporation law of the State ... [and] except to the extent otherwise provided in the governing instrument of a statutory trust, the trustee, when acting in such capacity, shall not be personally liable to any person other than the statutory trust or a beneficial owner for any act, omission or obligation of the statutory trust or any trustee thereof.”

Similar protection is granted to employees and officers of a statutory trust. Section 3806 of the same statute states that “except to the extent otherwise provided in the governing instrument of a statutory trust, the business and affairs of a statutory trust shall be managed by or under the direction of its trustees [and] a governing instrument may contain any provision relating to the management of the business and affairs of the statutory trust, and the rights, duties and obligations of the trustees, beneficial owners and other persons, which is not contrary to any provision or requirement of this subchapter....”

9 For a different evolutionary twist, see section 17-401 of the Delaware ULPA, which permits a general partner (even a sole general partner) that has no economic interest in the limited partnership.

For an excellent analysis of the evolution of LLPs, see Keatinge, Donn, Coleman, and Hester, “Limited Liability Partnerships: The Next Step in the Evolution of the Unincorporated Business Organization,” 51 Business Lawyer 147 (November 1995).

10 The evolution of and changes in state unincorporated entity statutes contributed to Treasury’s decision to replace the “four factors” partnership classification test in the old “Kintner Regulations” with the generally elective check-the-box approach of the current Regulations. See TD 8697, 12/17/96.

11 Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01, April 2001) (the “2001 JCT Report”), page 277. Also see id., page 280 (“... most State law with respect to limited partners [provides] that a [limited partner] is prohibited from, or limited in, participation in the management or business of the partnership”).

The JCT Staff’s statements in 2001 were erroneous in that ULPA (1976) with 1985 Amendments, section 303, introduced a wholly new concept that it is not sound public policy to hold a limited partner who is not also a general partner liable for the obligations of the partnership except with respect to persons who have done business with the limited partnership believing, based on the limited partner’s conduct, that he is a general partner. ULPA (2001) goes even further, eliminating the so-called “control” rule with respect to a limited partner’s personal liability for entity obligations “and bring[ing] limited partners into parity with LLC members, LLP partners and corporate shareholders.” ULPA (2001), section 303—Comments (quoted in part 6 of Exhibit 2 in this article, “Limitations on Limited Partners’ Activities”).

12 Under the 1976 version, a “limited partner” would lose his limited liability protection if: “in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business. However, if the limited partner’s participation in the control of the business is not substantially the same as the exercise of the powers of a general partner,

he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control.” ULPA (1976), section 303(a), 6B U.L.A. 180 (2008). As to potential liability of limited partners under ULPA (1976) for their partnerships’ obligations, see generally Banoff, “Can Tax Practitioners Support the Revised ULPA?,” 60 Taxes 97 (February 1982) (“ULPA Support article”).

- 13 Those provisions are analyzed in greater detail in the text, below.
- 14 See, e.g., Frost, “Square Peg, Meet Round Hole: Classifying LLC Members as General Partners or Limited Partners for Federal Tax Purposes,” 73 Taxes 676 (December 1995) (the “Round Hole article”); Banoff, Frost, and Keatinge, “Defining ‘General Partner’ and ‘Limited Partner’ for Federal Tax Purposes,” 96 TNT 37-82, 70 Tax Notes 1019 (2/19/96) (the “1996 Special Report”); Banoff, Frost, and Keatinge, “Determining Whether Members of LLCs Should Be Treated for Tax Purposes as General Partners or Limited Partners,” LLC Advisor (June 1996), page 4; Banoff and Lipton, “Passive Losses, LLCs and LLPs—Two Courts Reject the Service’s Attempt to Limit Losses,” 111 JTAX 204 (October 2009).
- 15 The partner-characterization issues discussed in this article also arise at the state tax level, as many states “piggyback” on federal tax law. See, e.g., Shop Talk, “Partners and LLC Members for California Tax Purposes: The Confusion Continues,” 114 JTAX 318 (May 2011) ; Shop Talk, “Are LLC Members GPs or LPs for State Tax Purposes? The Question Won’t Go Away!”, 104 JTAX 380 (June 2006) ; Shop Talk, “Are LLC Members GPs or LPs for Federal or State Tax Purposes?,” 98 JTAX 62 (January 2003) ; and Shop Talk, “LLC Members—GPs or LPs for State Tax Purposes?,” 88 JTAX 316 (May 1998).
- 16 See, e.g., Frost and Banoff, “Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs,” 100 JTAX 326 (June 2004) (the “Black Hole article”).
- 17 See, e.g., the Round Hole article, *supra* note 14, and the Black Hole article, *supra* note 16.
- 18 This was acknowledged by the Tax Court (two years before the decision in Renkemeyer, Campbell & Weaver, LLP, 136 TC 137 (2011)) in Garnett, 132 TC 368 (2009) (“The Code and regulations provide no general definition of ‘limited partner’”). The Service also has acknowledged that neither the Code nor the Regulations define “limited partnership” or “limited partner,” in TAM 9110003 (inapplicability of Section 1402(a)(13) to a putative limited partner).
- 19 Definitions in Section 7701 and the Regulations thereunder are applicable “when used in this title,” i.e., for all purposes of the Code, except “where not otherwise distinctly expressed or manifestly incompatible with the intent thereof”; see Section 7701(a). The definitions of “partnership” and “partner” in Section 761 are solely for purposes of Subtitle A, the income tax rules, and thus technically are not applicable for estate and gift tax purposes (Subtitle B), employment taxes (Subtitle C), or other miscellaneous taxes or provisions (Subtitles D through J).
- 20 For a comprehensive (although now outdated) listing, see the 1996 Special Report, *supra* note 14.
- 21 As discussed in the legislative history of Section 1402(a)(13), for tax purposes a partner could hold both a “limited partner” and a “general partner” interest in the same tax partnership, with different tax consequences arising from each type.
- 22 The Tax Distinctions article, *supra* note 1.
- 23 *Id.*
- 24 “In the absence of a definition, it must be presumed that Congress intends words used in the statute to have their natural, ordinary and familiar meaning.” Aven, 42 AFTR 2d 78-6120 (DC Okla., 1978), citing Salt, 350 US 383, 100 L Ed 441, 1956-1 CB 677 (1956).
- 25 See, e.g., Johnson, TC Memo 1990-461, PH TCM ¶90461 ; Norwood, TC Memo 2000-84, RIA TC Memo ¶2000-084 ; Gamma Farms, 66 AFTR 2d 90-5252 (DC Calif., 1990), *rev’d by unpubl’d opn.* 956 F2d 1166 (CA-9, 1992).
- 26 The Service has concluded that “[w]hether a partnership qualifies as a limited partnership is a question of state law.” See Ltr. Rul. 9110003.
- 27 Accord: Jackel, “Has Politics Trumped Policy?,” 131 Tax Notes 745 (5/16/11).
- 28 2011 NYSBA Report, *supra* note 5.
- 29 *Id.* NYSBA is of the view that variation of “limited partner” and “general partner” classification based on the state law classification of the individual’s interest is “inappropriate.” *Id.*
- 30 See the text accompanying notes 92-95, *infra*.
- 31 It is recognized that for tax purposes a taxpayer could be classified as a “general partner” with respect to some part of the ownership interest in the LLE, and a “limited partner” with respect to the remainder of the ownership interest in that entity. See note 2, *supra*.
- 32 2010 Instructions for Form 1065, U.S. Return of Partnership Income, page 2, “General Instructions—Definitions.”
- 33 *Id.* The instructions’ definition of “limited partner” does not stop there, however, but provides that some members of other entities, such as domestic or foreign business trusts or LLCs that are classified as partnerships, may be treated as limited partners for certain purposes. See the discussion in the text, below, of alternative 4, the “Comprehensive Approach Based on State Law Characterization Approach With Exceptions.”

- 34 The district court paraphrased the Service's position, based on the Temporary Regulations, as turning (in the absence of a specific designation in the LLC agreement or certificate) on "whether there is limited liability under state law. If a partner has limited liability in the partnership under state law, the partner has a limited partnership interest, and therefore, is a limited partner in the partnership" for Section 469 purposes. See Banoff and Lipton, *supra* note 14, page 209, fn. 21.
- 35 See Banoff and Lipton, *supra* note 14, page 209. The court in Gregg, 87 AFTR 2d 2001-337, 186 F Supp 2d 1123 (DC Ore., 2000), further stated that in the absence of any Regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, the Service's conclusion (that for purposes of Section 469, *all* members of an LLC taxable as a partnership will be treated as limited partners) was inappropriate. *Query* whether the district court would have ruled that *all* LLC members *would be* classified as limited partners under Section 469 if a (temporary or final) Regulation had been promulgated on point under Section 469?
- 36 See, e.g., ULPA (1976) with 1985 Amendments, sections 403(a) and 1105; ULPA (2001), section 406(a); UPA (1914), section 18(e); UPA (1997), section 401(f).
- 37 Alternatively, certain of the general partners may contractually agree (e.g., by the terms of their partnership agreement) not to participate in the management of, or provide services to, the partnership. In so doing, they effectively forgo exercising their right to participate (by choice). Nonetheless their right to participate still may exist, but doing so presumably would at a minimum constitute a breach of contract (breach of partnership agreement).
- 38 See note 11, *supra*.
- 39 *Id.*, page 280.
- 40 See Sowell, "Partners and the SECA Tax," PLI (2011).
- 41 For example, activity sufficient to cause one to be engaged in a trade or business. *Cf.* Section 162.
- 42 2001 JCT Report, *supra* note 11, page 286. An hours-per-year test would be administratively simpler, and easier for taxpayers to apply, than a subjective test that did not provide for quantifiable services.
- 43 The application of the six other non-tax factors generally would not change with respect to an LLE member, absent amendment of the entity's partnership or operating agreement (e.g., the member's authority to bind the entity) or a change in the state's applicable LLE act (e.g., pertaining to the right of a state law limited partner to participate in the management or activity of the limited partnership).
- 44 All of the proposed solutions outlined above and discussed in greater detail in the Round Hole article, *supra* note 14, are still viable alternatives, even with the continued evolution of tax and state LLE laws in the interim.
- 45 Note 14, *supra*.
- 46 See "ABA Comments on Treatment of LLC Members as General or Limited Partners," 96 TNT 232-15 (which includes the full text of a letter dated 11/21/96 from Steven C. Salch, Chair, ABA Section of Taxation, to the Commissioner of Internal Revenue, "Re: Comments Concerning Treatment of Members of Limited Liability Companies as General Partners or Limited Partners for Federal Income Tax Purposes"). The comments were prepared by members of the ABA Section of Taxation's Task Force on Limited Liability Companies and were reviewed by members of the ABA Section of Taxation's Committee on Government Submissions, but the comments represent the individual views of the members who prepared it and do not necessarily represent the position of the ABA or the ABA Section of Taxation. The ABA comments also were submitted to the Acting Assistant Secretary (Tax Policy), Department of Treasury, and the Chief Counsel, IRS.
- 47 Under state statutes, all general partners have apparent authority in limited partnerships and LLLPs; in the overwhelming majority of state LLC statutes, all members have apparent authority in member-managed LLCs, and all managers have apparent authority in manager-managed LLCs.
- 48 See, e.g., the Special Report, *supra* note 14, pages 1020-22.
- 49 See, e.g., ULPA (1976) with 1985 Amendments, section 801(4) (re general partners). Different rules have been adopted by ULPA (2001).
- 50 See the "TEFRA Audit Rules" discussion under "How 'Limited Partner' and 'General Partner' Have Been Defined," in the text, below. The TEFRA Conference Report indicates the focus on "general partners" in Section 6231 is based on the assumption that general partners have authority to bind the partnership and are most likely to be in a position to provide notice to other partners. H. Rep't No. 97-760, 97th Cong., 2d Sess. 600-612 (1982).
- 51 In fact, under ULPA (2001), section 305(a), limited partners have no fiduciary duties to their partnership or other partners.
- 52 See, e.g., Keatinge, "Duties in Allotment: Duties of Tax Partners With Respect to Inconsistent Positions," 88 Taxes 213 (March 2010); Banoff, "Partner/Partnership Wars, Return Preparer Dilemmas and Ethical Conundrums: Inconsistent Tax Reporting Positions in Passthrough Entities," 88 Taxes 123 (March 2010).
- 53 Prop. Reg. 301.7701-1 (REG-119921-09, 9/14/10). See Carman, Frost, and Bender, "First Steps—Proposed Regulations on Series LLCs Provide Clarity," 113 JTAX 325 (December 2010).
- 54 The author thanks Robert R. Keatinge, Esq., for identifying this alternative approach to defining "limited" and "general" partners.

- 55 That is, corporations substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. See Section 448(d)(2)(A).
- 56 In addition to the eight fields listed in Section 448 (see note 55, *supra*), the fields of athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees. See Section 1202(e)(3)(A).
- 57 See the text following note 47, *supra*.
- 58 See notes 32 and 33, *supra*, and the accompanying text.
- 59 Rev. Proc. 95-10, 1995-1 CB 501.
- 60 The 1994 Proposed Regulation (Prop. Reg. 1.1402(a)-18; EE-45-94, 12/28/94; 59 Fed. Reg. 67253) treated certain LLC members as limited partners for SE tax purposes. The 1997 Proposed Regulation (Prop. Reg. 1.1402(a)-2; REG-209824-96, 1/10/97) withdrew the 1994 proposal and replaced it with a rule that would apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity.
- 61 Possibly the “correct” Section 6231 solution in this circumstance may be that no member is a manager, in which event the rules for selecting the TMP should be the same as for a limited partnership with no general partner.
- 62 See Gregg, *supra* note 35. See also Thompson, 104 AFTR 2d 2009-5381, 87 Fed Cl 728 (Fed. Cl. Ct., 2009).
- 63 See, e.g., Shop Talk, “LLCs vs. LLPs: The Impact of RRA ’93,” 79 JTAX 386 (December 1993). In support of applying Section 736(b)(3) to LLC members, see Shop Talk, “More on LLCs vs. LLPs—Another View,” 80 JTAX 127 (February 1994).
- 64 In Garnett, *supra* note 18, the absence of explicit treatment of LLC (and LLP) interests in the Regulations was recognized by the Tax Court: “In the final analysis, and *absent explicit regulatory provision*, we conclude that the legislative purposes of the special rule of section 469(h)(2) are more nearly served by treating L.L.P. and L.L.C. members as general partners for this purpose” (emphasis added). In Gregg, *supra* note 35, the court concluded that “in the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership, [such a] conclusion is inappropriate.”
- 65 See note 60, *supra*.
- 66 See, e.g., Nalle, III, 72 AFTR 2d 93-5705, 997 F2d 1134 (CA-5, 1993); Bauer, 55 AFTR 2d 85-433, 748 F2d 1365 (CA-9, 1984). See Shop Talk, “Court Gives Legal Effect to Preamble to Proposed Regs.!,” 80 JTAX 62 (January 1994), and Shop Talk, “What is Legal Effect of Proposed Regs.?,” 69 JTAX 279 (October 1988).
- 67 See Karlinsky, “Self-Employment Taxes and PALs: The Case of LLCs,” 132 Tax Notes 1391 (9/26/11), 2011 TNT 186-11 (“A former Treasury official told me the department had been working on finalizing LLC self-employment regulations when [Steve] Forbes started calling those regulations a stealth tax and talked to [Rush] Limbaugh, who complained on the radio about their unfairness. [Newt] Gingrich was driving to Washington when he heard about the regulations and called in to Limbaugh’s radio program and promised to kill them”).
- 68 See the Preamble to REG-209824-96, *supra* note 60.
- 69 According to the Preamble, by adopting these functional tests the Proposed Regulations “ensure that similarly situated individuals owning interests in entities formed under different statutes or in different jurisdictions will be treated fairly.” The need for a functional approach results not only from the proliferation of new business entities (such as LLCs), but also from the evolution of state limited partnership statutes.
- 70 See Willis and Postlewaite, *Partnership Taxation*, Seventh Edition (Thomson Reuters/WG&L, 2011), ¶9.01[13].
- 71 Levine and Paul, “IRS Shifts Focus with Controversial New SE Tax Proposed Regulations,” 86 JTAX 325 (June 1997), citing UPA section 9, RUPA section 301, and *Bromberg and Ribstein on Partnership* (Little, Brown & Co., 1996), §14.01(b).
- 72 The 1994 Proposed Regulation was withdrawn when Prop. Reg. 1.1402(a)-2 was issued in 1997. See note 60, *supra*. The 1994 Proposed Regulation’s focus on the right to make management decisions as a defining factor is essentially the approach discussed above. See “Comprehensive Approach With Uniform Application—Rights to participate in management (or activity) of the entity.”
- 73 Levine and Paul, “Prop. Regs. Use ‘Management Rights’ Litmus Test for LLC Members’ SE Tax Liability,” 82 JTAX 196 (April 1995).
- 74 See the Preamble to REG-209824-96, *supra* note 60. The intent of the 1994 Proposed Regulations was to treat owners of an LLC interest in the same manner as similarly situated (general and limited) partners in a state law partnership. *Id.*
- 75 As to whether members of a law firm LLC could be characterized as “limited partners” (so as to avoid NEFSE), see Shop Talk, “Are Lawyers Exempt from Self-Employment Taxes?,” 82 JTAX 190 (March 1995).
- 76 The state-by-state answer might differ, i.e., it might depend on the location of the law firm’s office(s), the applicable state limited partnership act, applicable licensing requirements, and (in some situations) state court rules of practice or bar association opinions. Conceivably, under the 1994 Proposed Regulation certain non-manager members of a law firm engaged in multi-state practice could be viewed as being subject to tax on NEFSE, while a non-manager co-member practicing in another state could avoid NEFSE under Section 1402(a)(13).

77 See March 1995 Shop Talk, *supra* note 75. Arguably, creditors could not reasonably believe such a person to be a general partner.

78 For example, under Prop. Reg. 1.1402(a)-18 only those who (along with others) collectively have “exclusive management authority” are treated as general partners. This approach gives the wrong result in the cases of (1) a manager-managed service business with respect to any member who has an interest based on skill, reputation, or service, but who is not a “manager” as defined in the Proposed Regulation, and (2) many member-managed firms.

79 Karlinsky, *supra* note 67.

80 See the Preamble to Prop. Reg. 301.6231(a)(7)-2. See generally the “TEFRA Audit Rules” portion of the next section of this article, “How ‘Limited Partner’ and ‘General Partner’ Have Been Defined.”

81 REG-146537-06, 11/3/11. Section 892 exempts from U.S. income taxation certain qualified investment income derived by a foreign government. The substantive and complex rules of Section 892 are beyond the scope of this article.

82 Many of these consent rights appear to be derived from ULPA (1976) with 1985 Amendments, section 303(b)(6). See Exhibit 2, item 3.

83 Support for this point can be found in Gregg, *supra* note 35, where the district court stated that the taxpayer “argue[s] that the limited partnership test, as set forth in [Temp. Reg.] 1.469-5T(e)(3)(i)(B) and recited by [IRS], is obsolete when applied to LLCs and their members, because the limited liability statutes create a new type of business entity that is materially distinguishable from a limited partnership. I agree.”

84 Elliott, “Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes,” 2011 TNT 48-3 (3/11/11) (remarks attributed to Robert G. Honigman).

85 S. Rep’t No. 99-313, 99th Cong., 2d Sess. 716 (1986).

86 *Id.*, page 718.

87 *Id.*, page 719.

88 *Id.*, page 720.

89 *Id.*, page 731.

90 *Id.*

91 See H. Rep’t No. 99-841, 99th Cong., 2d Sess. II-145 (1986).

92 The court observed that a limited partnership must have at least one general partner who is personally liable for the obligation(s) of the entity. The court reasoned that if, for federal tax purposes, an LLC is treated as a limited partnership, and all members of the LLC are treated as limited partners because of their limited liability, the consequence of that treatment does not satisfy the state law requirement of “at least one general partner.” See Banoff and Lipton, *supra* note 14, page 209.

93 *Id.*, page 208.

94 The opinion in Thompson was issued by the Court of Federal Claims only 20 days after the Tax Court’s opinion in Garnett was released. Nevertheless, the Court in Thompson was well aware of Garnett and cited it in its opinion.

95 AOD 2010-14, 4/5/10.

96 Section 736(b)(1).

97 Section 736(b)(2). The difference between these approaches is that effectively a distribution is not deductible by the partnership while a payment that is treated as an allocation is deductible. See 2 McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, Fourth Edition (Thomson Reuters/WG&L, 2007), ¶16.02, page 16-10 et seq.

98 Section 736(b)(3).

99 H. Rep’t No. 103-111, 103d Cong., 1st Sess. 781 (1993).

100 *Id.*, page 782.

101 *Id.* The House also was motivated by concerns regarding the valuation of goodwill and other factors that might result in a deferral of income.

102 *Id.*

103 *Id.*, page 783.

104 H. Rep’t 103-213, 103d Cong., 1st Sess. 698 (1993).

105 Income of a landowner from certain activities involving agricultural and horticultural commodities is not excluded from NEFSE if the taxpayer materially participates (without regard to activities of an agent) in such activities; see Section 1402(a)(1). See Reg. 1.1402(a)-4(b) for a discussion of what constitutes active or material participation for this purpose. This is not to say, however, that a participation test is appropriate for any other purpose of Section 1402.

106 Section 1402(a)(13) was originally enacted as Section 1402(a)(12).

- 107 See the Report of the Committee on Ways and Means on the Social Security Amendments of 1949 (H.R. 6000), which explained the provision in relevant part as follows: “The net earnings from self-employment include, in addition to the earnings from a trade or business carried on by him, his distributive share of the net income or loss from any trade or business carried on by each partnership of which he is a member.... The net earnings from self-employment of a partner include his distributive share of the net income or loss of a partnership of which he is a member, irrespective of the nature of his membership, as for example, as a *limited or inactive member*.” H. Rep’t 1300, 81st Cong., 1st Sess. 136-137 (1949), 1950-2 CB 294 (emphasis added). See Cokes, 91 TC 222 (1988).
- 108 H. Rep’t No. 95-702, 95th Cong., 1st Sess. (Part 1) 11 (1977), 1978-1 CB 469, 477.
- 109 *Id.*, page 40. See also Norwood, *supra* note 25 (the general partner’s distributive share of the partnership’s trade or business income was held subject to SE tax regardless of whether the partner’s involvement was passive or active).
- 110 *Id.*, pages 40-41.
- 111 *Id.* Other perceived evils also were discussed. For example, “the advertising injures the social security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under social security, as well as those people without work income who would like to be able to become insured under social security programs but cannot afford to invest in limited partnerships.”
- 112 Prior to the 1997 Proposed Regulation, the Service provided informal guidance as to whether an LLC or LLP member was subject to SE tax, in each instance holding they were. See, e.g., Ltr. Ruls. 9432018 (LLC member), 9452024 (same), 9525058 (same), and 9630012 (LLP member). In Ltr. Rul. 9452024, the IRS recognized that, for some purposes under the tax law, an LLC member may be treated as a “limited partner,” noting specifically Temp. Reg. 1.469-5T(e)(3).
- 113 See note 60, *supra*, and the text accompanying notes 72-73, *supra*. Also see Levine and Paul, *supra* note 73.
- 114 Prop. Reg. 1.1402(a)-2(h)(2).
- 115 See Levine and Paul, *supra* note 71.
- 116 Prop. Reg. 1.1402(a)-2(h)(5).
- 117 Prop. Regs. 1.1402(a)-2(h)(6)(ii) and (iii). In part, the amendments to the SE tax Proposed Regulations—particularly the provisions relating to authority and to service partners in service partnerships—were similar to the recommendations of the authors of the 1996 Special Report (see note 14, *supra*), but for the unrequested participation test.
- 118 See note 67, *supra*.
- 119 See “ABA/AICPA Have Legislative Fix for LLC Self-Employment Tax Problems,” 84 Tax Notes 416 (7/19/99).
- 120 Sections 1256(d)(3)(C)(i) and (ii). The legislative history states that an individual who actively participates in the management of an entity is not considered a limited partner or a limited entrepreneur with respect to the entity for the period of the individual’s active management. S. Rep’t No. 97-144, 97th Cong., 1st Sess. (1981).
- 121 Specifically, for purposes of defining a “syndicate” under Section 1256(d)(3)(B), Section 1256(d)(3)(C) provides that an interest in an entity will not be treated as “held by a limited partner,” among other things, (1) for any period if during such period such interest is held by an individual who actively participates at all times during such period in the management of such entity, (2) for any period if during such period such interest is held by certain related parties of an individual who actively participates at all times during such period and the management of such entity, (3) if such interest is held by an individual who actively participated in the management of such entity for a period of not less than five years, or (4) if Treasury determines (by Regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or are not to be used) for tax-avoidance purposes.
- 122 H. Rep’t No. 97-760, 97th Cong., 2d Sess. 600-612 (1982).
- 123 See Reg. 301.6231(a)(7)-2(b)(3).
- 124 Reg. 301.6231(a)(7)-2(b)(1). As with Prop. Reg. 1.1402(a)-18, LLPs and LLLPs may be treated as LLCs in identifying TMPs. The Regulation also provides that any other reasonable method for selection of an LLC’s TMP will be binding for periods before the effective date of the Regulations.
- 125 As stated elsewhere in this article, in classifying members of unincorporated entities, there is sparse authority as to the definition of “general partner” or “limited partner” in the Regulations (and virtually no guidance in the Code). For purposes of the TEFRA TMP rules, we do find some guidance as to the characterization of interest owners of REMICs as “general partners” or “limited partners.” REMICs are subject to the TEFRA partnership procedures under Section 860F(e), which provides that the residual interest holders will be treated as partners. A REMIC does not have a traditional “general partner” who can be designated as the TMP under Section 6231(a)(7). Accord: CCA 201124023. To fill this void, Reg. 1.860F-4(d) provides that all residual interest holders are treated as “general partners” for TMP designation purposes.
- 126 In Block, TC Memo 1980-554, PH TCM ¶80554, the taxpayer raised the argument that her husband (Block) was a limited partner who took such an active part in controlling the partnership business that he became liable as a general partner under ULPA (1916) section 7. If Block were deemed to be treated as a “general partner” for purposes of the Code’s basis provisions, he then would be permitted to increase his share of liabilities (and therefore, his basis) in accordance with his

ratio of sharing losses under the partnership agreement, pursuant to Reg. 1.752-1(e) as it then existed. (That increased basis would permit him to be allocated certain ordinary and capital losses of the partnership, and to reduce the gain on his sale of a portion of his partnership interest.) Where the limited partnership itself has assumed a liability, pursuant to the Regulation only the general partners shared in that liability and only they benefited from the basis increase. The court identified the taxpayer's argument that Block was not, for purposes of applying Reg. 1.752-1(e), a limited partner of the partnership but rather "was a general partner," based on the following assertions and arguments:

(1) Under Pennsylvania partnership law, a limited partner may "become liable as a general partner" if, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business;

(2) Block took part in the control of the partnership business and thus would have been liable as a general partner under the Pennsylvania ULPA; and

(3) Since Block would have been treated as a general partner of the partnership under state law, he should be so treated for purposes of applying Reg. 1.752-1(e).

The Tax Court stated that item 3 above "present[ed] an intriguing issue," citing generally the Tax Distinctions article, *supra* note 1. Nevertheless, the court sidestepped the issue because the taxpayer failed to prove her husband (the limited partner) took part in the control of the partnership in such a manner that he would have, under Pennsylvania law, become liable as a general partner. As the court found as a fact that Block did not participate in the control of the partnership's business, the court concluded it "need not decide what effect a contrary finding on that state law issue would have on petitioner's Federal income tax liability."

In *Gamma Farms*, *supra* note 25, the Ninth Circuit was faced with the alleged SE tax liability of a partner who was denominated a limited partner in the partnership agreement and had validly executed a certificate of limited partnership. Because the advisors failed to file the limited partnership certificate with the state, the partner arguably was not a limited partner for state law purposes under the then-current California version of ULPA. In reversing the district court, the Ninth Circuit noted its belief that, given the positive actions taken and the lack of bad faith by the partner, state law would still protect the partner from "liability as a general partner." Accordingly, the partner was treated as a "limited partner" for purposes of Section 1402(a)(13), and not liable for SE tax. *Query* whether the Ninth Circuit would have characterized him as a "general partner" for tax purposes solely because he was "liable as" a general partner under state law (but clearly did not have the rights and powers of a general partner under state law).

127 Perhaps the quoted statements referring to becoming a general partner should merely be read as less-than-exact shorthand for the phrase "liable as a general partner."

128 See ULPA Support article, *supra* note 12.

129 Emphasis added; quoting the Tax Distinctions article, *supra* note 1. The dissenting opinion noted that on the facts at hand, both general and limited partners were personally liable for a pro rata portion of this partnership obligation, and thus being similarly situated, should be treated equally for federal tax purposes "unless the statute compels us to do otherwise, which it does not. Consequently, to the extent the majority opinion distinguishes between, and turns upon, State [partnership] law characterizations of general and limited partners, it may be correct for State law purposes, but for Federal tax purposes the majority ignores both form and substance and unduly extends section 465."

130 See, most recently, Prop. Reg. 1.892-5(d)(5)(iii), *supra* note 81, and Prop. Reg. 1.469-5. See the text following note 39, *supra*.

131 Note 14, *supra*.

Exhibit 1 Footnotes

1 OD 236, 1 CB 5 (1919)OD 236, 1 CB 5 (1919).

2 Woodruff, 38 BTA 739 (1938), *nonacq.*

3 Banoff, "Tax Distinctions Between Limited and General Partners: An Operational Approach," 35 Tax L. Rev. 1 (Fall 1979), fn. 16 (the "Tax Distinctions article").

4 Crane and Bromberg, *Law of Partnership* (1968), pages 13-14, 143-45.

5 Note 3, *supra*.

6 Letter dated 12/13/95 from Sheldon I. Banoff, Steven G. Frost, and Robert R. Keatinge, in their individual capacities.

7 See "ABA Comments on Treatment of LLC Members as General or Limited Partners," 96 TNT 232-15 (which includes the full text of the letter dated 11/21/96).

8 See, e.g., Levine and Paul, "IRS Shifts Focus With Controversial New SE Tax Proposed Regulations," 86 JTAX 325 (June 1997).

9 See "ABA/AICPA Have Legislative Fix for LLC Self-Employment Tax Problems," 84 Tax Notes 416 (7/19/99). For the text of the proposal, see "ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Tax," 1999 TNT 133-23.



Sheldon I. Banoff, P.C.

Partner

Chicago

p / 312.902.5256

f / 312.902.1061

sheldon.banoff@kattenlaw.com

Sheldon I. Banoff has concentrated in the area of federal income taxation for over 30 years, with particular concentration in investment, real estate, partnership and limited liability company taxation matters. His practice includes the representation of major real estate developers, syndicators, lenders and investors, including both taxable and tax-exempt investors and professional service (including law and accounting) firms.

In addition to his work on behalf of the firm's clients, Mr. Banoff is also a nationally and internationally known author and lecturer. Editor of the *Journal of Taxation's* monthly "Shop Talk" column since 1985, he has also written over 200 leading articles in the tax area. He is co-author of two books: "Illinois Limited Liability Company - Forms and Practice Manual" (Data Trace Legal Publishing Inc. 2009) and "Limited Liability Companies and S Corporations" (Illinois Institute of Continuing Legal Education 2010). Also, Mr. Banoff has been a Lecturer in Law at the University of Chicago Law School, where he taught an Advanced Seminar on Real Estate Transactions with emphasis on choice of form of entity, fiduciary duties, economic analysis of investments and taxation matters. He also serves on the Law School's Annual Tax Conference Planning Committee (which he chaired in 1993 and 1994).

A past chairman of the Chicago Bar Association's Federal Taxation Committee, he now serves on its Executive Council. He is actively involved in the American Bar Association Section of Taxation, and is a frequent program speaker on partnership, limited liability company and tax planning matters. Actively involved in executive compensation and professional firm organization and management matters, Mr. Banoff is past Chairman of the Chicago Bar Association's Large Law Firm Committee and counsels law and accounting firms on various tax and non-tax matters.

Mr. Banoff, a frequent spokesperson on taxation matters, has been interviewed on television and radio, and in magazines and newspapers. At the request of the Committee on Ways and Means of the U.S. House of Representatives, he has testified on partnerships and other pass-through entities. Mr. Banoff has annually been selected by a national poll of lawyers as one of "The Best Lawyers in America" (1987–2012) and is listed in "Leading Illinois Attorneys," *Illinois Super Lawyers'* "Top 100 Lawyers in Illinois" (2005–2010), "Who's Who in American Law," *Euromoney's* "Guide to the World's Leading Tax Attorneys," "The International Who's Who of Business Lawyers-Corporate Tax," *Chambers Global's Directory*, "The World's Leading Lawyers" and *Chambers USA: America's Leading Lawyers for Business* (2003–2011). He is a member of the Chicago Federal Tax Forum and elected as a Fellow of the American College of Tax Counsel.

Mr. Banoff graduated with high honors from the University of Illinois at Chicago with a Bachelor of Science degree in Accounting and received his law degree in 1974 from the University of Chicago Law School, where he was Associate Editor of the *Law Review*.

Katten

www.kattenlaw.com

Katten Muchin Rosenman LLP

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND WASHINGTON, DC

© 2012 Katten Muchin Rosenman LLP. All rights reserved.

Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997).
London affiliate: Katten Muchin Rosenman UK LLP.

1/27/12