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Passive Losses, LLCs and LLPs—Two Courts Reject the Service's Attempt to Limit Losses

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IRS characterized LLC members and LLP partners as "limited partners" for purposes of the passive loss rules, even though those entities were not state law limited partnerships. Although the taxpayers were victorious in the Tax Court and the Court of Federal Claims, there are many unanswered questions and a glaring need for clarification of what "general partner" and "limited partner" mean.

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Under Section 469, passive losses (generally) may offset only passive income. It is easier for a general partner than a limited partner to participate materially in an activity. This is important because unless the partner can demonstrate his material participation, his share of the partnership's losses generally is deemed by Section 469(c)(1)(B) to be a passive activity loss rather than an ordinary loss.

In *Garnett,* 132 TC No 19, Tax Ct Rep (CCH) 57875, 2009 WL 1883965 , and *Thompson,* 104 AFTR 2d 2009-5381, 87 Fed Cl 728 (Fed. Cl. Ct., 2009), decided 20 days apart, the Tax Court and the Court of Federal Claims rejected the Service's attempt to treat both the members of LLCs and the partners in limited liability partnerships (LLPs) as limited partners for purposes of the passive loss rules.[1] The courts essentially concluded that, absent direct statutory or regulatory guidance, the taxpayers could not be treated as subject to the more restrictive rules applicable to limited partners under Section 469, particularly in light of the taxpayers' extensive involvement in their respective activities.

OVERVIEW

The definition of a "limited partner" for purposes of various operative provisions of the Code has long been a mystery,[2] and its meaning for purposes of the passive loss rules is no exception.[3] In the context of Section 469 and its Regulations, the courts in *Garnett* and *Thompson,* and earlier in *Gregg,* 87 AFTR 2d 2001-337, 186 F Supp 2d 1123 (DC Ore., 2000), reached conclusions that are both logical and administrable.

Indeed, as sometimes seems to happen, the more difficult task is to determine why the IRS even litigated these cases at all (particularly given the taxpayer-favorable facts), unless the Service was simply trying to get the law clarified in this area. Of course, Treasury and the IRS could have done that years ago by promulgating Regulations to define a "limited partner" for purposes of the passive loss rules. Perhaps the Service was concerned that, if it took a position similar to that it espoused in these cases, the proposed rules would not have survived notice and comment. In any event, it can be hoped that in light of the pro-taxpayer decisions of two courts with significant tax expertise, the IRS will acquiesce in these decisions so as to provide certainty for taxpayers.

This article will analyze the characterization of members of LLCs and partners in LLPs as "limited partners" or "not limited partners" under the passive activity rules of Section 469, in light of the applicable Regulations and recent judicial developments. An understanding of the members' limited liability and level of permissible activity or participation allowable under state law for each form of unincorporated entity is helpful in preparation for the tax analysis.

We then will extrapolate how the general and limited partners of a limited liability limited partnership (LLLP) should be treated for purposes of Section 469. This article also will discuss whether the current Regulations should be modified and/or whether the IRS should change its stance on audit and litigation with respect to Section 469 and members of pass-through entities. Finally, we will analyze whether these cases provide guidance as to the classification of members of unincorporated entities for purposes of other operative Code provisions (e.g., Sections 736, 752, 1402(a)(13), and 6231) where guidance is lacking or sketchy at best.

Limited and General Partners Under Section 469

Section 469(a) provides a limitation on the ability of certain taxpayers (including individuals) to use losses or credits from passive activities in determining their income. A passive activity is defined in Section 469(c) as any rental activity or any trade or business activity in which the taxpayer does not materially participate.

Section 469(h)(1) provides that a taxpayer materially participates in an activity only if he is involved in the activity's operations on a regular, continuous, and substantial basis. Section 469(h)(2) provides, however, that (except as provided in Regulations) "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."

Section 469(l) authorizes Regulations that may be "necessary or appropriate to carry out provisions of this section," including in subsection (3) Regulations "requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity."

In connection with enacting Section 469, 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." [4]

The Senate committee did not believe losses from limited partnership interests should be available to offset positive income from other sources. [5] The Senate Report explains that "[l]osses and credits attributable to a limited partnership interest generally are treated as arising from a passive activity." [6] Special considerations exist for determining what is a passive activity in the case of limited partnerships because limited partnerships are often pooled in order to make passive investments. The Senate 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. [7]

The Senate Report provides that limited partnership interests are conclusively presumed not to involve material participation by the taxpayer unless otherwise provided by Regulations. The basis for this 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." [8]

The reason Treasury has the power to specify when limited partnership 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. [9] 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...." [10]

In 1988, Temporary Regulations were issued that define material participation. (The "Temporary" Regulations, now over 20 years old, remain unchanged—and in force and effect albeit still labeled "temporary"—to this day.) Under Temp. Reg. 1.469-5T(a), seven tests are created for determining whether an individual materially participates in an activity; a taxpayer must satisfy one of these tests. Specifically, an individual may establish his material participation in an activity for a given tax year by demonstrating any of the following:

> (1) The individual participated in the activity for more than 500 hours during such year.
> (2) The individual's participation in the activity for the tax year constituted substantially all of the participation in such activity of all individuals for that year.
> (3) The individual participated in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year was not less than the participation in the activity of any other individual for that year.
> (4) The activity was a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during that year exceeded 500 hours.
> (5) The individual materially participated in the activity for any five tax years during the ten tax years that immediately preceded the tax year.
> (6) The activity was a personal service activity, and the individual materially participated in the activity for any three tax years preceding the tax year.
> (7) Based on all facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during that year.

In contrast, under Temp. Reg. 1.469-5T(e)(2), if an individual is a limited partner in a partnership, the individual can materially participate in an activity only if the first, fifth, or sixth test set forth above is satisfied. Thus, as a practical matter, an individual who participates for less than 500 hours in the tax year in an activity in which the taxpayer *is* a limited partner generally cannot materially participate in the activity (unless the taxpayer materially participated in the activity in prior years), whereas a taxpayer can

establish material participation on several other bases if the individual is *not* a limited partner (e.g., is a general partner).

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 of the following conditions is met:

> (1) The interest is designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under state law.
> (2) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount (e.g., the sum of the holder's prior capital contributions and contractual obligations to make additional capital contributions to the partnership).

Finally, Temp. Reg. 1.469-5T(e)(3)(ii) provides that if a person is both a general partner and a limited partner in the same partnership, the limited partnership interest will *not* be treated as a limited partnership 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. [11]

PARTICIPATION AND LOSS OF LIMITED LIABILITY

To properly analyze the treatment of members of unincorporated entities for purposes of Section 469 (and other operative Code provisions), it is helpful to understand the outer boundaries of a member's participation in the business of each type of entity, without loss of the member's limited liability. Conversely, it may be relevant for tax planning purposes to identify whether material participation (as a member of a limited liability entity) will likely cause the member to lose his (generally desired if not required) limited liability shield. This topic was analyzed at length in (and the ensuing analysis derives in substantial part from) a prior article in The Journal on limited liability entities. [12] The following discussion addresses this question for limited partnerships, LLPs, LLCs, and LLLPs formed under state statutes, and helps set the table for our tax analysis under Section 469 *et al.*

Limited Partnerships

A limited partnership is formed under state law and generally is a partnership with two classes of partners—one or more general partners and one or more limited partners. The general partners typically have management power and personal liability for all of the obligations of the partnership, whereas the limited partners typically lack substantial management powers and enjoy immunity from liability for the debts of the partnership. A limited partner is usually viewed as a passive investor who would lose his limited liability if he participated in control of the partnership's business and affairs.

This dichotomy as to control and limited liability was at its strongest under the Uniform Limited Partnership Act (1916) (ULPA). [13] It has weakened, however, under subsequent revisions of the uniform act, i.e., RULPA 1976, [14] RULPA 1985, [15] and ULPA 2001, [16] and limited partners in many states can now participate in significant activities of the limited partnership, without loss of limited liability.

LLPs

An LLP is not formed as a limited partnership. Rather, an LLP is a general partnership that is permitted under applicable state law to make a filing or registration that provides a form of limited liability for its general partners. Frequently, the liability of a partner in an LLP is tied to the partner's own actions or inaction, whereas a limited partner in a limited partnership has no personal liability for any of the obligations of the partnership.

LLLPs

An LLLP is a limited partnership whose general partners are also shielded from personal liability for some or all of the partnership's debts. [17] The shield already exists with respect to the LLLP's limited partners, of course, although in some instances the vicarious liability protection afforded limited partners in an LLLP is thought to be slightly greater than under traditional limited partnership law. [18]

LLCs

An LLC is expressly *not* a partnership under state law. Instead, an LLC is a legal entity which is a hybrid; the members can participate directly in the management of the business but have limited liability for the company's debts and obligations. Absent an election to be taxed as a corporation, however, an LLC is treated as a partnership for tax purposes under Reg. 301.7701-3.

Of all types of unincorporated business entities allowed by state law, the LLC has attracted the most attention for the past 20 years. Every state and the District of Columbia now has an LLC statute. While these statutes vary from state to state, the 1996 Uniform Limited Liability Company Act (ULLCA) has been adopted in a number of states, and is used as the reference point in our discussion.

Generally, there are two types of LLCs: manager-managed and member-managed. Some observers analogize member-managed LLCs to general partnerships and manager-managed LLCs to limited partnerships. To some extent these analogies are helpful, although not entirely accurate.

With respect to both types of LLCs, the liability of the members and managers is addressed in ULLCA section 303(a). It provides that a member or manager is not personally liable for debts or obligations of an LLC "solely by reason of being or acting as a member or manager." Section 303(c) of ULLCA provides, however, that members may be liable in their capacity as members for debts or obligations of an LLC if so provided in the articles of organization and if the member or members who are liable have agreed to such liability in writing.

In a member-managed LLC, ULLCA section 301(a) provides that each member is an agent of the LLC and an act of a member "for apparently carrying on in the ordinary course of the company's business or business of the kind carried on by the company binds the company, unless the member had no authority to act for the company in the particular matter and the person with whom a member was dealing knew or had notice that the member lacked authority."

ULLCA section 404(a) provides that in a member-managed LLC, each member has equal rights in the management of the LLC's business. This section also provides that most

matters relating to the business of the LLC may be decided with the consent of a majority of the members, and a specific list of those items that require consent by all members is included in this section. In summary, provisions governing member-managed LLCs are substantially identical to the provisions in the Revised Uniform Partnership Act (RUPA) that address authority and management of a general partnership.

In a manager-managed LLC, the agency authority described above is vested solely in the managers. ULLCA section 301(b)(1) provides that in a manager-managed LLC, a member is not an agent of the LLC. Instead "each manager is an agent of the company for the purpose of its business, and an act of a manager for apparently carrying on in the ordinary course of the company's business or the business of the kind carried on by the company binds the company, unless the manager had no authority to act for the company in the particular matter and the person with whom the manager was dealing knew or had notice that the manager lacked authority." [19]

Similarly, in the context of management, ULLCA section 404(b) provides that in a manager-managed LLC, each manager has equal rights in the management of the LLC. Members have no rights per se in the management of a manager-managed LLC. As with member-managed LLCs, there are certain items listed in section 404(c) that require the consent of members of the manager-managed LLC.

APPLYING THE 469 REGS. TO LLCs AND LLPs: CASES

The application of Temp. Reg. 1.469-5T to LLCs was not the subject of any case, Revenue Ruling, or Regulation prior to 2000. The *Gregg* case, which the court believed to be one of first impression, was decided in 2000, and remained the sole authority until *Garnett* and *Thompson* were recently decided.

Gregg

In *Gregg,* the district court effectively held that a member of an LLC should be treated as a general partner rather than a limited partner for purposes of determining under Section 469 whether a loss is from a passive activity. The court framed the question as being "whether plaintiff, a member of an LLC, should be treated as a limited partner or as a general partner in a limited partnership for Section 469 purposes."

A careful review of the court's analysis and holding, however, 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).

The taxpayer argued that he should be treated as a general partner. Recognizing that the LLC was designed to be taxable as a partnership for federal income tax purposes, the taxpayer noted that state law (Oregon) distinguished limited partner status from general partner status based on a taxpayer's "control" of a business entity, rather than liability. Under Oregon law, general partner status was conferred on a person who was not a limited partner, i.e., was a partner who was not subject to restrictions on participation in the control of the business. [20] According to the taxpayer, because none of the members of the LLC were subject to restrictions under Oregon law or the LLC's articles of organization and operating agreement, all members of the LLC, including the taxpayer, should have been treated as general partners.

The Service argued that a member of an LLC—indeed, *all* members of LLCs—should be treated as a limited partner 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. [21] 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 the members' unrestricted ability to participate in the control of the business under Oregon law—because of their limited liability under Oregon law.

The court disagreed with the Service's position. The 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. 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 such treatment does not satisfy the state law requirement of "at least one general partner."

Further, the court noted that LLC members retain their limited liability regardless of their level of participation in the management of their LLC, whereas a limited partner in a limited partnership cannot, by definition, participate in management. The court 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 Section 469, *all* members of an LLC taxable as a partnership will be treated as limited partners) was inappropriate.

The court then considered the seven tests for material participation in Temp. Reg. 1.469-5T(a), and determined that Gregg materially participated in the activity. Therefore, his losses were not passive activity losses.

In reaching its conclusion, the district court did not discuss or distinguish section 70.135 of the Oregon Limited Partnership Statute. That provision allows limited partners to vote, approve, propose, and disapprove 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 *Gregg* court did not conclude that Temp. Reg. 1.469-5T(e) was invalid or incorrect as a matter of policy; rather, it found the Temporary Regulation to be "obsolete when applied to LLCs and their members." [22] The court stated that the legislative history of Section 469 clearly showed "that Congress enacted the limited partnership test to thwart the deduction by investors, such as limited partners in a limited partnership, of 'passive losses' from 'tax shelter' investments against other non-passive income, since 'a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status.'" [23] Because LLCs are designed to permit active involvement by LLC members in the management of the business, the court concluded that the limited partnership test "is not applicable to *all* LLC members" (emphasis added). [24]

It has been observed in a prior article in The Journal [25] that it may have been better for the court to have simply concluded the Temporary Regulations were incorrect and that the test to be applied to LLC members should be based on levels of activity under the general partner tests.

The Recent Cases: *Garnett* and *Thompson*

The facts in these two recent cases were relatively straightforward.

In *Garnett,* the taxpayers owned interests in seven LLPs[26] and two LLCs formed under Iowa law that were engaged in agribusiness operations, primarily the production of poultry, eggs, and hogs. They also owned certain tenancy-in-common (TIC) interests in two other business ventures through five additional LLCs.

The LLP agreements provided that each partner would actively participate in the control, management, and direction of the LLP's business. No partner, however, was liable for the partnership's debts or obligations except as required by law. In the LLCs, the members selected a manager that had the exclusive authority to act for the company; the taxpayers were not the managers of the agribusiness LLCs (although the taxpayers were the managers of the LLCs that held the TIC interests). The various LLPs and LLCs owned by the taxpayers incurred substantial losses.

In *Thompson,* the taxpayer formed Mountain Air Charter, LLC (Mountain Air), to operate a charter business. The taxpayer held 99% of the interests in Mountain Air directly and held 1% through JRT Holdings, Inc., an S corporation. The taxpayer was the sole manager of Mountain Air. Mountain Air incurred substantial losses.

The positions of the parties. In both *Garnett* and *Thompson,* the application of the passive loss rules was raised on motions for summary judgment.[27]

The government essentially argued in both cases that the taxpayers did not have unlimited liability, and therefore each LLC and LLP interest in question was a "limited partnership interest" under Temp. Reg. 1.469-5T. Therefore, the taxpayers had to be treated as "limited partners" for purposes of applying the passive loss rules.

The taxpayers, on the other hand, argued that neither the Code nor the Regulations made "limitation of liability" applicable for purposes of the passive loss rules. The taxpayers interpreted "limited partner" as being solely a limited partner in an entity classified as a limited partnership under state law. Read literally in this fashion, a member of an LLC or LLP could not be a "limited partner" because neither an LLC nor an LLP is, strictly speaking, a (state law) limited partnership. Since the taxpayers were not "limited partners" in the LLPs or the LLCs, they contended that the special rules applicable to limited partners in Section 469(h)(2) and Temp. Reg. 1.469-5T should not apply.

The *Garnett* opinion. The first of these opinions was the Tax Court's decision in *Garnett.* The court noted, initially, that in 1986 when Congress enacted Section 469(h)(2) and in 1988 when the relevant Regulations were promulgated, LLPs did not exist; the first state LLP statute was adopted in 1991. Furthermore, although Wyoming had adopted an LLC statute prior to 1986, as a practical matter LLCs were hardly used until sometime after the IRS issued Rev. Rul. 88-76, 1988-2 CB 360, which clarified that an LLC could be treated as a partnership for tax purposes. And very few states had enabling LLC legislation until several years later. Thus, it was not surprising that neither the Code (as enacted in 1986) nor the Regulations (promulgated in 1988) makes any reference to either LLCs or LLPs or the members thereof.

In *Garnett,* the IRS acknowledged that there are legal differences between limited partnerships on the one hand and LLCs and LLPs on the other. The Service contended, however, as it did in *Gregg,* that the "sole relevant consideration" in applying Section 469(h)(2) was whether the taxpayers enjoyed limited liability with respect to their ownership interests. In the Service's view, each member of an LLP and LLC interest who

enjoys limited liability owns a "limited partnership interest" under Temp. Reg. 1.469-5T—end of story. The taxpayers, in contrast, argued that unless a taxpayer was explicitly a limited partner in an entity classified as a limited partnership under state law, Section 469(h)(2) was per se inapplicable.

The Tax Court readily rejected the Service's broad argument because Section 469(h)(2) does not focus on whether a taxpayer has limited liability but rather on whether the taxpayer holds an interest in a limited partnership *as a limited partner.* The court did not stop there, however. While acknowledging that the legislative history of Section 469 was "not free of ambiguity," the Tax Court concluded that the legislative history "suggests that Congress contemplated" that the IRS would have the authority to treat "substantially equivalent entities" as limited partnerships for purposes of Section 469(h)(2). [28] Therefore, the Tax Court also rejected the taxpayers' broad argument that Section 469(h)(2) could not apply unless the taxpayers were limited partners in an entity classified as a limited partnership for state law purposes. Thus, the Tax Court has rejected both the Service's argument (that *all* LLC members are limited partners under Section 469(h)(2)) and the taxpayer's argument (that *no* LLC members are limited partners for purposes of Section 469(h)(2)).

The Tax Court focused, instead, on the potential application of the so-called "general partner exception" in Temp. Reg. 1.469-5T(e)(3)(ii). If this exception applies, then the ownership interest in the legal entity cannot be treated as a limited partner interest.

The exception is phrased in terms of partners who, at the same time, hold an interest as both a limited partner and a general partner in a state law limited partnership. [29] The Tax Court observed, however, that by its terms the general partner exception is not expressly confined to such a situation. Moreover, the IRS did not argue that the exception was categorically unavailable to members of LLCs or LLPs. Instead, the Service contended that the availability of the general partner exception depended on the extent of the authority and control that the LLP or LLC member enjoyed.

The Regulations under Section 469 do not define a "general partner," and there is no general definition of "general partner" found in the Code or elsewhere in the Regulations. The IRS contended, by reference to an old Supreme Court decision, [30] that a "general partner" is the person who has authority, actual or apparent, to act for and bind the partnership. [31] Furthermore, the IRS agreed that in *Garnett,* Iowa law did not preclude the taxpayers from actively participating in the management and operations of LLPs and LLCs. Nevertheless, the IRS argued that the agreements at issue did not give the taxpayers the same authority to take action on behalf of the entities as a general partner would have with respect to a limited partnership.

Thus, the IRS argued that the application of the general partner exception depended on the nature and extent of a taxpayer's authority to act on behalf of the entity. The Tax Court rejected this approach, however, on the grounds that these tests were similar to the factual inquiries appropriately made under the general tests for material participation. To import them into the per se rule in Section 469(h)(2) was viewed as blurring together that special rule and the general rules for material participation.

Furthermore, the court decided that the legislative history did not support the Service's approach. The legislative history indicated that Congress believed that limited partners were legally precluded from participating in the activities of the partnership if they wished to maintain limited liability status. Thus, while limited liability was one characteristic of a limited partnership interest that Congress considered important, the more direct and germane consideration was the legislative belief that statutory constraints on a limited

partner's ability to participate in the partnership's business justified a presumption that a limited partner generally does not materially participate and made further factual inquiry into the matter unnecessary.

The Tax Court concluded that this rationale did not properly extend to interests in LLPs and LLCs. Members of LLPs and LLCs—unlike limited partners in limited partnerships—are not barred by state law from materially participating in the entities' business. Accordingly, it cannot be presumed that they do not materially participate. Rather, it is necessary to examine the facts and circumstances to ascertain the nature and extent of their participation. This examination is appropriately conducted using the broader material participation rules in Section 469 and Temp. Reg. 1.469-5T(a), not the more limited rules applicable to limited partners.

In summary, the Tax Court concluded that the taxpayers held their ownership interests in the LLPs and LLCs in question as "general partners" for purposes of applying the Regulations under Section 469. The court recognized that the taxpayers' interests were not the same as those of state law general partners, but these interests also differed significantly from those of state law limited partners as well. The need to "pigeonhole" these LLP and LLC interests as either general partner or limited partner interests arose from the fictions in the Regulations, the court said, and the purposes of Section 469 as well as the goals set forth in its legislative history were better served by treating LLP and LLC members as general partners for the purposes of this provision. [32]

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

In *Thompson,* in which the taxpayer owned an LLC interest in Mountain Air LLC, the taxpayer and the IRS agreed that Section 469 would limit his losses if his interest in the LLC was treated as a limited partnership interest under Temp. Reg. 1.469-5T(e)(3), and further agreed that his losses would not be limited if the LLC interest was not treated as a limited partnership interest. Thus, the matter would be decided by the interpretation of Temp. Reg. 1.469-5T(e)(3).

The *Thompson* court noted, at the threshold, that an LLC is not a partnership. While LLC members may participate directly in the management of the company, all members enjoy limited liability regardless of their respective levels of involvement. Limited partnerships, on the other hand, must distinguish between (1) their limited partners who have limited liability but are unable to participate in the management of the partnership, and (2) their general partners, who may participate in the management of the partnership but are personally liable for its debts. [33]

The IRS argued, first, that it was proper to treat the taxpayer's interest in the LLC as a limited partnership interest because Mountain Air was treated as a partnership for tax purposes. The taxpayer responded that because Mountain Air was not a limited partnership, his interest could not be that of a limited partner. Moreover, the taxpayer contended that even if Mountain Air were analogized to a limited partnership, his interest was more akin to that of a general partner, given the high degree of control he exerted over Mountain Air's business.

The IRS argued that the Court of Federal Claims owed substantial deference to an agency regulation promulgated in accordance with an express congressional mandate and to an agency's reasonable interpretation of such a regulation. The court concluded that it owed no deference to the Service's proffered interpretation of the Regulation, because the

taxpayer agreed that the Regulation was valid, and the IRS did not set forth, nor was the court aware of, any official IRS interpretation extending Temp. Reg. 1.469-5T(e)(3) to include memberships in LLCs. [34]

The court rejected the Service's first argument for the simple reason that Temp. Reg. 1.469-5T(e)(3) applies solely to entities that are limited partnerships for state law purposes. It was not sufficient that the entity was taxable as a partnership; this Regulation applies only to entities that *are* partnerships for state law purposes. The court viewed the language of the Regulation as clear and unambiguous—it applies to state law partnerships and to no other entities.

Moreover, the court viewed the language in the Regulation as consistent with 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. To be subject to this provision, a taxpayer must actually be a limited partner. Since Mountain Air was organized under state law (Texas) as an LLC, not a limited partnership, by definition the taxpayer's interest in Mountain Air could not be an interest in a limited partnership as a limited partner.

In addition, the court noted that the taxpayer likely met the general partner exception in Temp. Reg. 1.469-5T(e)(3)(ii) because the taxpayer was both the manager and a member of Mountain Air. At oral argument, the IRS twice conceded that the taxpayer would be a general partner if Mountain Air were a limited partnership. Thus, the IRS was taking the inconsistent positions that the taxpayer's interest in Mountain Air should be treated as a limited partner's interest in a limited partnership without giving the taxpayer the benefit of the general partner exception that applies to limited partnerships. The court described the Service's position as "entirely self-serving and inconsistent." The court reasoned that if an LLC member could somehow hold a limited partner's interest under Temp. Reg. 1.469-5T(e)(3)(i), then, alternatively, the same member could hold a general partner's interest under Temp. Reg. 1.469-5T(e)(3)(ii).

The IRS also argued that the taxpayer must be treated as holding a limited partnership interest because, at the time Section 469 was enacted, the states all agreed that the most significant feature of a limited partnership interest was limited liability. The taxpayer contended, in contrast, that the key feature or attribute differentiating a limited partner's interest from that of a general partner was the ability to participate in the control of the business.

The court looked at the state of partnership law at the time Congress enacted Section 469 and agreed with the taxpayer. In reaching this conclusion, the court emphasized that pursuant to ULPA, RULPA 1976, and RULPA 1985, a limited partner would lose his limited liability status if he participated in the control of the business of the partnership. Stated another way, a limited partner's level of participation in the business dictated whether or not he enjoyed limited liability. The converse, however, was not true—limited liability was not the *sine qua non* of a limited partnership interest.

Furthermore, the *Thompson* court rejected the Service's argument that the statutory and regulatory framework divided between two types of partnership interests based on limited liability. The court concluded that the Code and Regulations focused on a different dividing line—participation. The terms used by Congress, including "material participation" and "passive activity," showed that Congress was primarily concerned with the taxpayer's level of involvement in the activity in question. If Congress had desired a test that turned on a taxpayer's level of liability, it could have used "liability" in Section

469. The IRS had to concede at oral argument that "liability" does not appear in Section 469.

The IRS also contended that the legislative history supported its position, but the court rejected this contention as well. First, the text of Section 469 did not demonstrate that Congress cared about a taxpayer's level of liability. Furthermore, shareholders in an S corporation enjoy limited liability and pass-through tax treatment, just as members in an LLC, but they are not held to the same material participation standards that apply to limited partners. If Congress were, in fact, trying to stem the use of limited liability pass-through entities as tax shelters, the disparate treatment of S corporations and LLCs would be inexplicable.

The court noted that the IRS was given regulatory authority to provide through Regulations that limited partnership interests would not be treated as interests in passive activities. This authority, however, was intended to provide exceptions to—and not to expand on—the general presumption that limited partners do not materially participate in their limited partnerships.

Most important, the court concluded that an LLC is not "substantially equivalent" [35] to a limited partnership. Unlike a limited partner, a member of an LLC is permitted to participate in the business of the LLC while retaining limited liability. The court concluded that it would make little sense to extend the Code's presumption concerning limited partners' lack of participation in their limited partnerships to LLCs and their members.

Finally, even if it were somehow concluded that an interest in an LLC could be subject to the rules applicable to limited partnerships, the court concluded that the so-called general partner exception under Temp. Reg. 1.465-5T(e)(3)(ii) would apply to the manager of an LLC even if he owned only one type of interest in the LLC. It cited *Garnett* as supporting this conclusion, noting that the legislative purposes of Section 469(h)(2) are better served by treating LLC members as general partners. According to the court, at best the IRS could point to some ambiguities in Temp. Reg. 1.469-5T(e)(3), but it was appropriate to decide such ambiguities in favor of the taxpayer.

The *Thompson* court also referred to *Gregg,* for its holding that an LLC interest was not treated as a limited partnership interest for purposes of applying the passive loss rules.

Because the parties had stipulated that the taxpayer in *Thompson* materially participated in Mountain Air unless the taxpayer's interest in Mountain Air was treated as a limited partnership interest, summary judgment was granted in favor of the taxpayer.

ANALYSIS

Over a dozen Code provisions and 70 Regulations explicitly refer to "limited partner" or "general partner." In addition, there are several other Code sections and Regulations whose operative effect turns on the taxpayer's status as a "limited partner" or "general partner," even though these terms are not explicitly used in the provisions in question (such as the tax treatment of limited and general partners with respect to imputation of a partnership's trade or business). [36]

The problem is compounded with respect to members of LLCs, who are treated as partners for federal tax purposes if (as is usually the case) the LLC is treated as a partnership for entity classification purposes under Reg. 301.7701-2. To date, Congress has provided no clarification as to the status of the LLC's members for federal income tax

purposes, and the IRS has failed to adopt a uniform (or even logically consistent) approach to classification of LLC members. [37]

In modern tax practice, limited partnerships are not used as commonly as LLCs or LLPs because someone (or some entity) must serve as the general partner of the limited partnership and have unlimited liability. Nevertheless, the taxpayer in *Thompson* might have chosen to form Montana Air as a limited partnership rather than an LLC, with the taxpayer being a 99% limited partner and JRT Holdings, Inc., his wholly owned S corporation, being the sole general partner with a 1% interest. For undisclosed (non-tax or tax) reasons he chose instead to form an LLC. If the taxpayer had used his wholly owned S corporation as the general partner, he likely would have been successful in arguing that the general partner exception applied to him, although there is no authority squarely on this point.

Until the recent *Garnett* and *Thompson* duo, *Gregg* was the only reported case to deal with the status of a member of an LLC for purposes of determining which of the seven material participation tests in Temp. Reg. 1.469-5T(a) apply. *Gregg* held that members of an LLC are not treated as limited partners in a limited partnership for purposes of Section 469, and therefore the higher standard of material participation test for limited partners should not be applied to the taxpayer. *Gregg* was a district court case, however, and is not binding on the Tax Court.

To the extent that there remained ambiguity (after *Gregg*) concerning how the passive loss rules apply to the members of LLCs (and whether they were treated as limited partners for such purposes), *Garnett* and *Thompson* are important because of their decisive conclusions that the membership interests in LLCs were *not* limited partner interests for purposes of Section 469. Moreover, the reasoning of each of these decisions, as well as the legislative history on which they rely, seems clear and to the point. The courts have definitively rejected the Service's arguments, and these questions should now be put to rest.

A tax practitioner is also likely to question why the IRS took the position it did in *Garnett* and *Thompson.* The Service's argument appears to have been very weak—it always seemed clear that an individual who is the manager of an LLC would be treated as a general partner for purposes of applying the passive loss rules. Indeed, if the taxpayer had desired passive income from the LLC's activity (because he had passive losses that he could not use), the taxpayer would potentially have been subject to penalties for taking a position (i.e., that he was a "limited partner" in a limited partnership for purposes of Section 469, notwithstanding his active participation as the manager-member of the LLC) that appeared to lack substantial authority. The IRS, however, appears to be willing to take positions that are very difficult to justify (other than on the grounds that the position would raise revenue in the case before the court). It is hoped the IRS will recognize that its long-term interests (as well as those of the tax system) are better served if the IRS takes only positions that are relatively defensible.

UNANSWERED QUESTIONS

Taken together, *Garnett* and *Thompson* provide substantial guidance on the application of the passive activity rules to members of LLCs and LLPs. Nevertheless, several questions remain unanswered, including the following:

How Will LLLP Members Be Classified for 469 Purposes?

Although *Gregg, Garnett* and *Thompson* all involved application of the passive loss rules to members of LLCs, *Garnett* remains the only case to rule on the status of members of LLPs under Section 469(h)(2) and Temp. Reg. 1.469-5T. No case or ruling has dealt with the application of the passive activity limitation rules to LLLPs. Over 30 states have enacted LLLP statutes, and it is only a matter of time until issues under the passive loss material participation tests arise for LLLP members, also.

Insofar as an LLLP is an entity formed under a state limited partnership statute, it is likely that the limited partners of an LLLP will be classified as owning limited partner interests in a limited partnership for purposes of Section 469(h)(2) and Temp. Reg. 1.469-5T(e)(3). Nothing in *Gregg, Garnett* or *Thompson* would indicate to the contrary. [38]

On the other hand, the treatment under Section 469 of a general partner of an LLLP is less clear. As a matter of state law, he owns a general (not limited) partner interest in a limited partnership, and thus would not appear at first glance to be a limited partner as the term is used in Section 469(h)(2). But *query* whether he would be deemed a limited partner under Temp. Reg. 1.469-5T(e)(3)(ii), because (1) his LLLP interest is in a state law limited partnership and (2) the Regulation says a partnership interest will be treated as a limited partnership interest if the liability of the holder of such interest for obligations of the partnership (e.g., the general partner) is limited under applicable state law to be a determinable fixed amount (e.g., the sum of the holder's capital contributions to the partnership and his contractual obligations to make additional capital contributions to the partnership). As noted above, [39] a general partner of an LLLP is not liable for obligations of an LLLP that arise while the partnership is an LLLP solely by reason of being or acting as a general partner. Does this mean his obligations as a general partner are limited so as to be a fixed amount?

If the answer is "yes," then a general partner of an LLLP will be treated as a limited partner for purposes of Temp. Reg. 1.469-5T, but a general partner of an LLP (which is a general, not limited, partnership for state law purposes, as discussed above) will not be treated as owning a limited partner interest in a limited partnership. That would be a somewhat absurd result.

Unfortunately, *Gregg, Garnett* and *Thompson* provide no direct guidance on LLLPs under Section 469 because those cases involve different legal entities (i.e., LLCs and LLPs, neither of which by definition is a state law limited partnership), while the LLLP is in fact a state law limited partnership, which is the entity meant to be covered in Section 469(h)(2). Indeed, *Thompson* states that (state law) limited partnerships (unlike LLCs) must distinguish between (1) their limited partners, who have limited liability but are unable to participate in the management of the partnership, and (2) their general partners, who may participate in the management of the partnership but are personally liable for its debts. Where on this spectrum should the general partners of an LLLP fall—directly in the middle? They can participate in the partnership's management (like general partners) but are not personally liable for the partnership's debts (like limited partners). Perhaps the answer will require still more litigation, which is unlikely to arise while LLLPs remain in their infancy.

We expect that in a case of first impression involving LLLPs, the courts will look to the Code, Regulations, and legislative history for guidance, as they did in connection with members of LLCs and LLPs. As was true for LLCs and LLPs, there were no LLLP enabling statutes (and no LLLPs in existence) when Section 469 was enacted (1986) or when Temp. Reg. 1.469-5T was promulgated (1988), so it cannot be said that Congress or the IRS contemplated LLLPs when considering the scope of the Code or Regulations. If the courts (like those in *Garnett* and *Thompson*) decide that the general partner exception is

available, the LLLP member would need to establish his participation in the control of the business of the LLLP to qualify for the exception.

What Impact Will the Cases Have on 'Limited Partner' for Other Purposes?

One's status as a "limited partner" or "general partner" has potential operative tax consequences under several other Code provisions and Regulations. [40] Most of these other provisions do not expressly describe how members of LLCs and LLPs will be classified for purposes of those operative provisions. What impact, if any, will the *Garnett* and *Thompson* cases have on interpreting the meaning of "limited partner" or "general partner" under these other provisions?

Space limitations prevent us from analyzing (or even summarizing) the multitude of provisions for which these terms have operative tax consequences. Also beyond the scope of this article is a detailed discussion of the various ways in which one might categorize partners of partnerships (limited and general partnerships, LLPs, and LLLPs) or members of LLCs as being a "general partner" or "limited partner" for each of these operative provisions, e.g., based on:

- Their level of activity in the partnership's business.
- Their participation in management or control of the business.
- Their actual or apparent authority to bind the partnership or LLC.
- Their potential limited (or unlimited) personal liability.
- Their characterization for state law purposes (e.g., as a state law limited or general partner; as a manager or non-manager of a manager-managed LLC).

Also not covered herein is the basic question of whether there can be or even should be a uniform definition of "limited partner" and "general partner" for all purposes of the Code, or whether each Code provision and Regulation will need to develop its own specific definitions of those terms, based on the policy or legislative intent underlying each of the relevant provisions. All of these questions are thoughtfully reflected upon in the articles mentioned earlier. [41]

Self-employment tax. It may be helpful, however, as a matter of illustration, to take one of these provisions and analyze the potential impact of *Garnett* and *Thompson* on the meaning of "limited partner" and "general partner." We focus on Section 1402(a)(13), in part because its usage of "limited partner" pre-dates Section 469(h)(2), and in part because the IRS in *Garnett* recognized an inverse relationship of the taxpayer's position under Sections 469(h)(2) and 1402(a)(13).

Some background on the scope and derivation of Section 1402(a)(13) may be helpful. [42] Section 1401 imposes Social Security taxes on the self-employment income of every individual. Section 1402(b) defines self-employment income as net earnings from self-employment (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). 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." [43]

The exclusion from NEFSE for income and loss of limited partners was enacted as part of the Social Security Amendments of 1977. The 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." [44] 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 provides 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. [45]

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." [46] 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." [47] Essentially, Section 1402(a)(13) was added to the Code to eliminate a tax shelter.

The Service tried on two occasions to define "limited partner" for purposes of Section 1402. In December 1994, the IRS issued the first set of rules addressing this issue, Prop. Reg. 1.1402(a)-18. [48] In response to comments on Prop. Reg. 1.1402(a)-18, early in 1997 the IRS withdrew the 1994 notice of proposed rulemaking and proposed amendments to Prop. Reg. 1.1402(a)-2.

Under the second set of Proposed Regulations, an individual generally would be treated as a limited partner under the revised rules unless the individual (1) had personal liability for debts of or claims against the partnership by reason of being a partner, (2) had authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership, or (3) participated in the partnership's trade or business for more than 500 hours during the partnership's tax year. [49] In addition, rules were included for bifurcating a member's interest so that the member of an LLC, for example, might be treated as owning both limited partner and general partner interests in the same LLC. Further, the amendments included various special rules. [50]

The Proposed Regulations included a special set of rules for service partners in service partnerships. An individual who was a service partner in a service partnership would not be treated as a limited partner. [51] A service partner was defined as 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. [52] In part, the amendments to the self-employment tax Proposed Regulations—particularly the provisions relating to authority and to service partners in service partnerships—were similar to the recommendations of the commentators, [53] but for the unrequested participation test.

The proposed amendments were heavily criticized, though not by practitioners. Congress, responding to populist-based criticism, enacted section 935 of TRA '97, providing 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 prior to 7/1/98. No new guidance has been issued since this moratorium. In July 1999, the American Bar Association recommended 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 self-employment taxes. [54] In light of the flurry of criticism and debate regarding the Proposed Regulations, it was observed that no new administrative action is likely to be taken prior to legislation.

The relevance of Section 1402(a)(13) to Section 469(h)(2) is fairly obvious: whereas the taxpayers in *Gregg, Garnett,* and *Thompson* sought to avoid "limited partner" status for purposes of Section 469(h)(2), they may have desired to be treated as "limited partners" for purposes of Section 1402(a)(13). [55] Indeed, the IRS, in its brief in *Garnett,* claimed that the taxpayers obtained self-employment tax avoidance benefits by not designating their LLC and LLP interests as "general partner" interests on their Schedules K-1. [56] Insofar as the taxpayers recognized losses, rather than income, from these ventures (at least initially), they may not in fact have obtained any tax benefits under Section 1402(a)(13).

It is by no means clear that the definitions of "limited partner" should be the same for purposes of Sections 469(h)(2) and 1402(a)(13). They do not serve the same purposes and are derived from different legislative concerns. Moreover, as stated in Prop. Reg. 1.1402(a)-2(h), Treasury and the IRS expressly restricted their efforts to define members of partnerships as limited or general partners as being "solely for purposes of Code Section 1402(a)(13)."

How Would Tiered Entities Affect 469(h)(2)?

There is little guidance in the Regulations, Rulings, or case law as to the analysis of "limited partner" or "general partner" status, for purposes of any operative Code provisions, where there are multiple tiers of ownership of pass-through entities.

For example, if A is a general partner of ABC General Partnership, and ABC itself is a limited partner in DEF Limited Partnership, should A be treated as a general partner or a limited partner, with respect to income, loss, activities, or matters pertaining to DEF? Should the answer be the same if ABC is a limited (not general) partnership, DEF is a general (not limited) partnership, and A is a limited (not general) partner in ABC? Is it appropriate to collapse any tiered ownership interest in a multi-tiered pass-through entity structure that includes one or more limited liability entities, in order to determine each member's authority, management rights, and limited or unlimited personal liability? [57]

In a similar vein, to what extent does the nature of an ownership interest in an intervening pass-through entity affect the applicability of the "limited partner" rule in Section 469(h)(2)? In *Garnett,* this factual scenario arose, but the Service concluded that the intervening entity's interests in the operating activity were to be disregarded for purposes of Section 469(h)(2) in this case, and were "of no consequence."

The Tax Court noted that the parties were seeking a ruling only with respect to the companies other than the holding LLCs. The court seemed puzzled as to the Service's de facto concession that the taxpayers would not be deemed "limited partners" although they enjoyed limited liability with respect to their (indirect) interests in the underlying entities, including (most surprisingly) the tenancies-in-common. [58]

It is unknown whether this was a strategic concession by the IRS or a misjudgment. It is also unclear whether the Tax Court would have changed its analysis or conclusion (in ruling for the taxpayers) had the Service contended that the taxpayers indeed had (indirect) limited liability so as to be treated as limited partners for purposes of Section 469.

Can IRS Prospectively Override the Cases?

The IRS has now lost all three cases (*Gregg, Garnett,* and *Thompson*) it has litigated involving the status of LLC members as not being "limited partners" under the material participation rules, and the only case litigated (*Garnett*) involving the status of LLP members. If the Service wishes to pursue the matter further, it may do so by additional litigation, which may not be ultimately resolved until a number of appellate courts have weighed in on the matter. Given the outcomes of the initial three cases, there is little reason to predict IRS will be successful on appeal or in new cases.

If Treasury and the IRS instead chose the course of amending Temp. Reg. 1.469-5T to include all or some members of LLCs, LLPs, and LLLPs, would that Regulation be respected by the courts (even if the Service were to give it prospective effect only)? Or are the existing cases in the aggregate of sufficient breadth and weight, and their reasoning so compelling, to cause such an amended Regulation to be invalidated with respect to members of limited liability entities other than state law limited partnerships? And could any such Regulation be issued in light of the (likely) vociferous comments that would result?

The answer is not certain and may depend in part on the scope and precise wording of an amended Regulation. As stated earlier, the district court in *Gregg* responded to the Service's position in part as follows: "*In the absence of any regulation* asserting that an LLC member should be treated as a limited partner of a limited partnership, defendant's conclusion is inappropriate. Therefore, the higher standard of material participation test for limited partners should not be applied to plaintiff" (emphasis added). [59]

The Court of Federal Claims in *Thompson* quoted this language, in stating that its holding (that the taxpayer can demonstrate material participation using all seven tests in Temp. Reg. 1.469-5T(a)) "accords with *Gregg.*" The Tax Court in *Garnett* also reached its pro-taxpayer conclusion "absent explicit regulatory provisions" dealing with members of LLCs and LLPs. [60] Can the negative inference be drawn that the courts would have ruled differently if the IRS had such an amended Regulation on the books? Or would the courts' conclusions have been the same in light of the statutory language in Section 469(h)(2) and the corresponding legislative history? And would Regulations, issued now (i.e., after these three cases), that broadly define a "limited partner" be valid?

One commentator concluded that Treasury should have the authority to issue Regulations treating LLP or LLC members as limited or general partners for purposes of Section 469. Although Section 469 does not specifically authorize such Regulations, Section 7805(a) authorizes Treasury to "prescribe all needful rules and regulations for the enforcement of" the Code. Such authority, she contends, should include the authority to provide definitions of "limited partner" and "general partner" for any purpose of the Code, including Section 469(h)(2). [61]

Would it even be wise for the IRS to issue Regulations that expand the definition of a limited partner? The focus in *Gregg, Garnett,* and *Thompson* is on the characterization of losses allocated to a member of an LLC or LLP (which losses, the IRS contended, were passive losses). The flip side of the equation also must be considered, i.e., an LLC or LLP

in a trade or business that generates taxable income or gain in any given year to its members. Under the Service's litigating position, the income or gain generally would have been passive income, because the LLC and LLP members would be treated as limited partners for purposes of Section 469(h)(2). [62] Thus, they would be deemed not to have materially participated in the LLC or LLP if they did not meet one of the three tests of Temp. Regs. 1.469-5T(a)(1), (5), or (6) (even if they did otherwise meet one of the other four tests in that Regulation). A new Regulation might give taxpayers the means to generate passive income more readily.

CONCLUSION

With the exception of *Gregg,* which is of weak precedential value, [63] there has been a 20-year gap between the issuance of Regulations and the development of case law as to the application of the passive loss material participation rules affecting members of limited liability entities. The delay in part is due to the entities' newness and taxpayers' reluctance to adopt their widespread use until all or virtually all jurisdictions enacted enabling legislation. The more recent proliferation of pass-through entities other than state law limited partnerships is widely recognized.

It has been suggested that the increased number of individuals engaged in private equity transactions and participating in the management of multiple entities is placing more taxpayers in the 100-to-500-hour per annum level of participation. [64] This in turn would place them within the "significant participation activity" level (which is relevant under the fourth material participation test, found in Temp. Reg. 1.469-5T(a)(4), to avoid passive loss status). That test is not available to those owning limited partner interests under Section 469(h)(2) and Temp. Reg. 1.469-5T(e). As a result, the holdings in *Garnett* and *Thompson* may take on even greater importance in the future. [65]

We agree with the courts' conclusions in *Garnett* and *Thompson* that the members of an LLC and the (general) partners of an LLP 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. [66]

Although *Garnett* and *Thompson* both conclude that taxpayers who are members of LLCs can use all seven material participation tests in Temp. Reg. 1.469-5T(a), there are some nuanced differences in their analysis. The Tax Court in *Garnett* left open the possibility that Section 469(h)(2) can apply to entities other than state law partnerships if they were "substantially equivalent" to a state law limited partnership. It is unclear what type of entity the Tax Court might have had in mind. [67] In contrast, the Court of Federal Claims in *Thompson* held that Section 469(h)(2) can apply only to interests in state law partnerships. It clearly would not entertain the possibility that an entity that is not a state law limited partnership could be a limited partnership for purposes of Section 469.

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 simply because he was a member of an LLC or an LLP, which as a matter of state law could not be a limited partnership. In *Thompson* (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. This is a potentially important distinction. 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. In *Garnett,* however, the Tax Court instead focused on the general partner exception in Temp. Reg. 1.469-5T(e), and concluded that with proper regard for the purposes of Section 469 and the goals set forth in its

legislative history, the Garnetts held their ownership interests as "general partners" within the meaning of the Regulation. Did the Tax Court leave the door ajar for the possibility that Section 469(h)(2) potentially could apply to entities other than state law partnerships if they were "substantially equivalent" to a state law limited partnership? If so, what (if anything) does the Tax Court have in mind? We are unaware of any such unincorporated limited liability entity that currently exists.

Another problem facing the IRS is whether it will have to contact taxpayers who want passive income and who assert the Service's litigating position against the IRS. Taxpayers may contend that the LLC member's share of income or gain would be passive, and thus could be used to "free up" passive losses that otherwise were subject to the passive loss limitation rules. Until and unless the IRS concedes that the Temporary Regulations do not deal with LLC or LLP members for purposes of Section 469, the Service could be stuck with applying its litigating position to profitable LLC and LLP interests, as well.

All of the courts observed (and undoubtedly, silently bemoaned) that there is no general definition of "limited partner" or "general partner" in the Code or Regulations and no specific definition for purposes of Section 469. To date, Congress has not moved forward to resolve the dilemma of characterizing members of LLCs and other unincorporated entities taxable as partnerships. Section 406 of H.R. 5166, the Tax Simplification Bill of 2002 (introduced 7/8/02 with 11 co-sponsors), would have directed Treasury to conduct a study on modernizing the use of the terms "general partners" and "limited partners" in the Code in light of the increased use of LLCs and other business entities classified as federal tax partnerships. H.R. 5505, the Individual and Small Business Tax Simplification Bill of 2002 (referred to Ways and Means on 10/1/02), would have modified most of the references to "general partners" and "limited partners" in the Code, creating a strict dichotomy based on whether the partner was prohibited or limited from participating in the management or business plan activity of the partnership. Neither of these provisions was enacted. Guidance is appropriate and needed.

Alternatively, is legislation solely under Section 469 appropriate to deal with LLCs, LLPs, and the "limited partner" rule under Section 469(h)(2)? Moreover, is it time to amend or repeal Section 469(h)(2) to eliminate the presumption of a lack of material participation by limited partners? Should Section 469 provide a more uniform approach to members of LLCs, LLPs, LLLPs, and plain vanilla limited partnerships, to reflect the substantial changes in the level of activities allowed under state law by so-called "passive members" of these entities (without their facing unlimited liability)?

Practice Notes

A problem that may face the IRS is whether taxpayers who want passive income will assert the Service's litigating position against it. Taxpayers may contend that the LLC member's share of income or gain would be passive, and thus could be used to "free up" passive losses that otherwise were subject to the passive loss limitation rules. Until and unless the IRS concedes that the Temporary Regulations do not deal with LLC or LLP members for purposes of Section 469, the Service could be stuck with applying its litigating position to profitable LLC and LLP interests.

[1] For purposes of this article, "member" and "partner" will be used interchangeably.

[2] See, e.g., Banoff, "Tax Distinctions Between Limited and General Partners: An Operational Approach," 35 Tax L. Rev. 1 (Fall 1979) (hereinafter "Tax Distinctions"); Frost, "Square Peg, Meet Round Hole: Classifying LLC Members as General Partners or Limited Partners for Federal Tax Purposes," 73 Taxes 676 (December 1995) (hereinafter "Frost"); Shop Talk, "Are LLC Members GPs or LPs for Federal or State Tax Purposes?," 98 JTAX 62 (January 2003). As used herein, except where stated otherwise, a "limited partnership interest" means the interest held by a limited partner (and not a general partner) in the partnership.

[3] See, e.g., Frost, *supra* note 2; Banoff, Frost, and Keatinge, "Defining 'General Partner' and 'Limited Partner' for Federal Tax Purposes," 70 Tax Notes 1019 (2/19/96).

[4] S. Rep't No. 99-313, 99th Cong., 2d Sess. 716 (1986).

[5] *Id.,* page 718.

[6] *Id.,* page 719.

[7] *Id.,* page 720.

[8] *Id.,* page 731.

[9] *Id.*

[10] See H. Rep't No. 99-841, 99th Cong., 2d Sess. II-145 (1986).

[11] Dual partnership interests, whose existence and use pre-date the passive activity rules, can arise for both non-tax and tax-related reasons. See generally Banoff, "New IRS Rulings Expand Opportunities When One Is Both a General and Limited Partner," 60 JTAX 366 (June 1984). The authors are unaware of any reported cases, Revenue Rulings, or other IRS guidance involving the application of Section 469 to one who is both a limited partner and general partner in the same partnership.

[12] Frost and Banoff, "Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs," 100 JTAX 326 (June 2004) ("Frost and Banoff"). We recognize and acknowledge Steven G. Frost's primary authorship of that article's analysis of member participation and limited liability for the various types of limited liability entities, from which our discussion is derived.

[13] Limited partnerships were developed to encourage investments by persons in business affairs of partnerships. ULPA (1916), Official Comment. To some extent, these laws also were intended to protect lenders who would receive a share of profits in lieu of interest. *Id.* In exchange for this limitation on liability, however, limited partnership statutes required that a limited partnership file a certification and that limited partners refrain from participating in the control of the business of the partnership. If the certification was not filed or a limited partner did not limit participation, such a partner would lose the shield of limited liability and be treated as a partner with respect to third parties, i.e., possess the obligations and liabilities of a general partner.

[14] With respect to agency, section 303 of the 1976 version of RULPA (RULPA 1976) provides that a limited partner may be a contractor for or an agent or employee of the limited partnership or a general partner without being deemed to be participating in the control of the business. Thus, a limited partner may have actual authority, but not apparent authority, to deal with third parties on behalf of the partnership and not be liable as a general partner to creditors of the partnership. Significantly, this authority is

not inherent in the nature of a limited partnership interest. Rather, a limited partner acting in any of these capacities is acting much like any third party who would be retained to act in this fashion. Frost and Banoff, *supra* note 12, page 332.

RULPA 1976 also made significant changes with respect to management. It provides that a limited partner who participates in enumerated activities listed in the statute will not be deemed to participate in control. For example, section 303(b) provides that a limited partner may consult with and advise a general partner with respect to the business of the partnership and may propose, approve, or disapprove, by voting or otherwise, numerous activities specified in the statute. Thus, under RULPA 1976, a limited partner may act as an agent of a partnership and participate in proposing, approving, or disapproving significant management decisions for the partnership without "becoming" liable as a general partner.

In effect, there are two potential levels of liability under RULPA 1976 if the limited partner is not a general partner. First, if the limited partner's participation is substantially the same as the exercise of powers of a general partner, he would be liable as a general partner. Second, if the limited partner participates in control, but such participation is not substantially the same as the exercise of powers of a general partner, then the limited partner may be liable only to persons who contract with the business having *actual* knowledge of such participation and control. Conduct of any of the activities enumerated in the safe harbors of RULPA 1976 would not result in any limited partner having any liability to third parties whatsoever (that is, solely in their capacity as a limited partner).

[15] With respect to management, the 1985 amendments to RULPA (RULPA 1985) expand the list of activities in which limited partners may participate without being deemed to be participating in control of the business of the partnership. Specifically, 1985 RULPA section 303(b) provides: "A limited partner does not participate in the control of the business within the meaning of subsection (a) [of 303] 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 §803; or (8) exercising any right or power permitted to limited partners under this [Act] and not specifically enumerated in this subsection [303(b)]."

Similarly, the 1985 amendments limit the circumstances under which a limited partner may be liable to third parties. As amended, section 303(b) of RULPA 1985 provides that a limited partner may be liable to third parties only if the limited partner also is a general partner or if persons transacting business with the partnership reasonably believe, based on the limited partner's conduct, that the limited partner is a general partner. In this

event, the limited partner does not become liable as a general partner per se, but rather he is liable only to the person or persons who reasonably believe, based on the limited partner's behavior, that the limited partner is a general partner. Thus, in no event would a limited partner be liable as a general partner for all obligations of the partnership (unless the limited partner also was a general partner). Instead, under RULPA 1985, the limited partner now may be liable only to persons who reasonably believe, based on the limited partner's behavior, that the limited partner is a general partner. This change in scope of liability is obviously significant.

The 1985 amendments to RULPA extended the agency authority that may be exercised by a limited partner without participating in control. As amended, section 303(b)(1) of RULPA 1985 provides that, in addition to not participating in control solely by being a contractor for or an agent or employee of a limited partnership or of a general partner, a limited partner does not participate in control by being an officer, director, or shareholder of a general partner that is a corporation.

[16] Section 302 of ULPA 2001 provides that a limited partner does not have the right or power as a limited partner to act for or bind the partnership, although official comments to this section make clear that a limited partner still may act for the partnership in another capacity, e.g., as an agent. Section 303 clearly provides that a limited partner is not personally liable for an obligation of the partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the partnership. Limited partners may participate to any extent in the management of the limited partnership.

[17] Section 404 of ULPA 2001 provides that an obligation of an LLLP that arises while a partnership is an LLLP is the obligation of only the LLLP, and a general partner is not liable for such obligations solely by reason of being or acting as a general partner.

[18] For an analysis of the advantages and disadvantages of using LLLPs, particularly for service partnerships, see Shop Talk, "Service Firms Practicing as LLLPs: What are the Tax Consequences?," 103 JTAX 124 (August 2005).

[19] It is understood that the vast majority of states vest agency authority in members of member-managed LLCs and in managers of manager-managed LLCs. Nevertheless, several states do not. For example, Del. Code Ann. title 6, §18-402 provides that "[u]nless otherwise provided in a limited liability agreement, each member and manager has the authority to bind the limited liability company." Admittedly, there is no uniformity among the states with regard to a number of state law issues, and these differences must be contemplated when considering the tax implications of using LLCs.

[20] Ore. Rev. Stat. 70.135.

[21] The district court paraphrased the Service's position, based on the Regulations, as turning (in the absence of a specific designation in the partnership 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.

[22] 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."

[23] Quoting from S. Rep't 99-313, *supra* note 4, page 720. See also notes 7 and 8, *supra,* and the accompanying text.

[24] *Query* whether the district court's use of the word "all" means that (1) the limited partnership test of Temp. Reg. 1.469-5T *is* applicable to *some* LLC members, i.e., those who do not participate, or (2) the court meant to say "the limited partnership test is not applicable to *any* LLC members." The latter seems to be the better reading, as the court did not look into Gregg's participation in the LLC's business for purposes of determining whether he was subject to the "limited partner" rule (whereby only three of the seven tests in Temp. Reg. 1.469-5T(a) would be available to him to prove his material participation in the LLC's activity). Rather, the court held that Gregg could satisfy any one of the seven tests in Temp. Reg. 1.469-5T(a).

[25] Frost and Banoff, *supra* note 12, at page 336.

[26] The taxpayers owned an interest in one LLP directly, and in six other LLPs indirectly through holding LLCs, which themselves apparently were taxable as partnerships.

[27] In Thompson, the parties agreed that if the taxpayer was a limited partner, he did not materially participate in the subject activities, whereas if he was not a limited partner, he materially participated in the activity. The facts in Garnett are somewhat murkier because the government reserved the right to argue that the activity was a rental activity (in which case the taxpayer's participation generally would not be relevant); the court simply focused on whether the limited partner exception in Section 469(h)(2) applied. The practical effect is that in Garnett, the motion was for partial summary judgment, which was not dispositive of all matters before the Tax Court; the motion for summary judgment in Thompson was so dispositive.

[28] As a corollary, this statement implies that Congress also contemplated that at least some owners of substantially equivalent entities might be treated as limited partners.

[29] See also note 11, *supra,* and the accompanying text.

[30] Giles v. Vette, 263 US 553, 68 L Ed 441 (1924).

[31] In a footnote, the Tax Court commented that it was not persuaded that Giles, *supra* note 30, "provides the all-purpose definition of 'general partner' which [the IRS] claims to discover there. The holding in Giles was that would-be limited partners in a failed limited partnership were not liable as general partners.... The Court in Giles was less concerned with the definition of a general partner than with the existence of a partnership. That is not the concern presented here." For an extensive analysis (predating passage of Section 469) of the federal income tax consequences that flow from the status of limited partners becoming liable as general partners, see Banoff, "Can Tax Practitioners Support the Revised ULPA?," 57 Taxes 97 (February 1982).

[32] 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).

[33] The Court of Federal Claims cited Gregg, 87 AFTR 2d 2001-337, 186 F Supp 2d 1123 (DC Ore., 2000), as well as Bromberg and Ribstein, *Bromberg and Ribstein on Partnership* (Aspen, 2007), §1.01(b)(3), for this statement. Nevertheless, to say that limited partners "are unable to participate in the management of the partnership" is overly broad. See the discussion in the text, above, of "Limited Partnerships," and

especially notes 13-16, *supra.*

[34] Thus, the court concluded in fn. 7 that since it owed no deference to the Service's proffered interpretation, it could "proceed unhindered in applying the appropriate canons of construction. See *Bowen v. Georgetown Univ. Hosp.,* 488 U.S. 204, 212-13 (1988) (holding that where the agency itself has articulated no position on the question, '[d]eference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate')."

[35] In Garnett, the Tax Court concluded that the relevant legislative history "suggests that Congress contemplated" that the IRS would have the regulatory authority to treat "substantially equivalent entities" as limited partnerships for purposes of Section 469(h)(2). See the discussion of the Tax Court's opinion in the text, above. In Thompson, after referring to the legislative history's reference to "substantially equivalent entities," see S. Rep't No. 99-313, *supra* note 4, at pages 731-32, the Court of Federal Claims stated this legislative history was ambiguous and unclear, and concluded that "[n]otwithstanding whatever the Senate report was attempting to convey, defendant's interpretation conflicts with the plain language of the statute."

[36] See, e.g., Banoff, Frost, and Keatinge, *supra* note 3; "Tax Distinctions," *supra* note 2.

[37] See, e.g., Banoff, Frost, and Keatinge, *supra* note 3; Frost, *supra* note 2.

[38] Compare Thompson's discussion of LLCs: "Finally and most importantly, an LLC is not 'substantially equivalent' to a limited partnership.... unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability" (citation omitted). The same cannot be said of LLLPs.

[39] See note 17, *supra.*

[40] See articles cited in notes 2, 3, and 12, *supra.*

[41] *Id.*

[42] See generally Frost and Banoff, *supra* note 12, pages 337-38, from which this overview is derived.

[43] Section 1402(a)(13) was originally enacted as Section 1402(a)(12).

[44] H. Rep't. No. 95-702, 95th Cong., 1st Sess. (Part 1) 11 (1977).

[45] *Id.,* page 40. See also Norwood, TC Memo 2000-84, RIA TC Memo ¶2000-084 (the general partner's distributive share of the partnership's trade or business income was held subject to self-employment tax regardless of whether the partner's involvement was passive or active).

[46] *Id.,* pages 40-41.

[47] *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."

[48] See Levine and Paul, "Prop. Regs. Use 'Management Rights' Litmus Test for LLC Members' SE Tax Liability," 82 JTAX 196 (April 1995). This Proposed Regulation was subsequently withdrawn.

[49] Prop. Reg. 1.1402(a)-2(h)(2).

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

[51] Prop. Reg. 1.1402(a)-2(h)(5).

[52] Prop. Regs. 1.1402(a)-2(h)(6)(ii) and (iii).

[53] See Banoff, Frost, and Keatinge, *supra* note 3, and Frost, *supra* note 2, page 698, for extensive discussion of this history.

[54] See "ABA/AICPA Have Legislative Fix for LLC Self-Employment Tax Problems," 84 Tax Notes 416 (7/19/99).

[55] This observation was identified by commentators in connection with the taxpayers' position in Gregg that a member of an LLC could not, by definition, own a limited partnership interest in a limited partnership. See Frost and Banoff, *supra* note 12, at page 336: "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 self-employment taxes [under Section 1402] on their shares of LLC income...."

[56] The IRS contended: "Petitioners cite nothing to support their contention that [for purposes of Temp. Reg. 1.469-5T] they held general partner interests. With the exception of one K-1, their interests were not described as "general partner" interests. On the Forms K-1, the only instance when a mark was placed in the box for 'general partner' was on the K-1 for GRD I (which operated a *per se passive* rental business). In each other instance, the box for 'limited partner' was marked, except in the two instances when the box for 'limited liability company member' was marked (one of which was Single Poultry Source, which also operated a *per se passive* rental business). "Petitioners obtained a tax benefit from the fact that their interests were not designated as 'general partner' interests. The benefit is that they avoided self employment tax on their distributive shares of partnership income. I.R.C. §1402(a)(13). These ventures were expected to be profitable. If petitioners were truly general partners, they would have been subject to self employment tax on the entities' net income. Petitioners should not be allowed to now claim 'general partner' status to gain a tax advantage from a characterization that they previously had disavowed. This is particularly so when, as here, the manner in which their interests were designated on the Forms K-1 was consistent with the nature of those interests, and the manner in which a 'limited partnership interest' is defined in §1.469-5T(e)(3)." Memorandum of Facts and Authorities in Support of Respondent's Cross Motion for Partial Summary Judgment, Docket No. 9898-06 (11/9/07), pages 15-16.

[57] In such case, these factors then may be used, together with any other relevant items (such as time devoted to the entity or activities of the entity), to characterize the member as a general partner or limited partner for tax purposes. See Frost and Banoff, *supra* note 12, at page 347.

[58] See fn. 13 of Garnett: "The parties seek a ruling only with respect to the companies other than the holding L.L.C.s. Respondent [IRS] asserts, and petitioners [taxpayers] do not dispute, that for purposes of applying sec. 469(h)(2) in this case, the intervening interests of the holding LLCs are to be disregarded. Respondent states: 'That petitioners

mostly held their interests indirectly (through Garnett Family Farm entities) is of no consequence.' In the light of the parties' seeming agreement on this point, we need not and do not consider further the extent to which the nature of an ownership interest in an intervening entity might be material in applying sec. 469(h)(2)."

The Tax Court's quotation of the Service's statement is correct, but it omits the Service's reference to the TRA '86 Blue Book for the following: *"The presumption that a limited partnership interest is passive applies even when the taxpayer possesses the limited partnership interest indirectly through a tiered arrangement ... [1986 Blue Book, 235-36 (1987)]."* (Emphasis in the original). See Memorandum of Facts and Authorities in Support of Respondent's Cross Motion for Partial Summary Judgment, Docket No. 9898-06 (11/9/07), page 2, fn. 1. The legal effect of the TRA '86 Blue Book is muddled, at best. See, e.g., Shop Talk, "Tax Court Gives TRA '86 Blue Book 'Lesser Respect,'" 84 JTAX 190 (March 1996); Shop Talk, "TRA '86 Blue Book: 'Precedential Value' or 'Lesser Respect'?," 91 JTAX 318 (November 1999); and Shop Talk, "Legal Effect of the TRA '86 Blue Book: Still Perfectly Unclear!," 96 JTAX 125 (February 2002).

Similarly, with respect to the properties reflected as tenancies-in-common, as characterized on their Forms 1065 and deemed to be so conceded by the IRS, the Service did not argue that the taxpayers in Garnett enjoyed limited liability with respect to their interests by virtue of the fact that they held the interests indirectly through a holding LLC. "To the contrary, as previously noted, respondent contends that it is of 'no consequence' that petitioners held interests indirectly through the holding L.L.C.s." See Garnett, fn. 27.

Indeed, the Service's reference to the TRA '86 Blue Book seems misplaced. The Blue Book presumably addresses situations where the bottom-tier (operating) entity is a limited partnership, and the holding company/unincorporated pass-through entity ("parent entity") in the tiered arrangement is *not* a limited partnership. In Garnett, the bottom-tier entities were *not* limited partnerships (but instead were LLCs, LLPs and tenancies-in-common). But then again, the holding companies (that the IRS stated on brief to be "of no consequence") are not state law limited partnerships, either. So the IRS likely would have lost its argument in Garnett regardless of whether the court ruled on the parent (holding company) entity or the bottom-tier (LLC, LLP, or T-I-C) entity.

[59] See also the discussion in the text, above, following note 37.

[60] See note 32, *supra.*

[61] See Kalinka, "*Garnett* and *Thompson*: Tax Court Holds LLC and LLP Members Are General Partners Under Code Sec. 469(h)(2); U.S. Court of Federal Claims Agrees, Part I—The Opinions and Their Value to Taxpayers," 87 Taxes No. 9 (September 2009), page 5.

[62] *Id.*

[63] Gregg's precedential value applies only to district courts in Oregon; unlike Garnett and Thompson, it is not a court of national jurisdiction with respect to tax deficiency or tax refund cases. Moreover, the discussion of limited vs. general partner status in Gregg should be viewed as dictum (albeit interesting dictum); the ultimate holding in Gregg is that the taxpayer (LLC member) could combine his participation in the LLC with his participation in another related business, so as to meet the material participation requirements (contained in the first test, i.e., Temp. Reg. 1.469-5T(a)(1)), regardless of whether the LLC member was classified as a limited partner or general partner.

[64] Coder and Elliott, "Another Court Rejects Passive Loss Limits on LLC Interests," 124 Tax Notes 311 (7/27/09) (observation attributed to Frederick N. Widen, Esq., of Ulmer & Berne LLP).

[65] An amicus brief in Garnett, filed by a law firm reportedly representing at least two clients whose cases were then being considered by Service's Appeals office on this issue, states the belief that the issue and outcome in Garnett is applicable "to potentially thousands of taxpayers." Amicus Brief of Ulmer & Berne LLP, at page 2.

[66] Accord: Frost and Banoff, *supra* note 12, at page 336.

[67] The Tax Court presumably was not thinking about LLLPs, which are in fact (and not merely substantially equivalent to) state law limited partnerships.