LLC material participation policy shift: new regulations focus on management rights

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ABSTRACT

Until it issued proposed regulations in November 2011, the IRS had treated members of limited liability companies (LLCs) and limited liability partnerships (LLPs) presumptively as limited partners for purposes of the passive loss limitations under an outdated set of § 469 temporary regulations issued in 1988. After losing several significant court cases, the IRS has relented and changed its limited partner test, shifting the focus from limited liability to managerial responsibility. The courts have held that LLC and LLP members should not presumptively be treated as "limited partners" when applying the regulations' material participation tests because state law allows members of these hybrid entities to participate in management. Thus, managing members frequently can meet one of the general material participation tests. While the IRS has taken a first step to resolve the issue, the proposed rules are unclear in some respects, and the new policy will not take effect until the regulations are finalized. The IRS also missed an opportunity to address a related LLC issue, the treatment of LLC members for purposes of the self-employment tax. Still, a significant policy shift has taken place that more accurately reflects the prevailing methods of doing business as a member-managed Limited Liability Company.

Keywords**:** passive losses, limited liability company or llc, limited liability partnership or llp, material participation, limited partner, general partner

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INTRODUCTION AND OVERVIEW

The hybrid entities, Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs), have existed since 1977. However, many lawyers and accountants who advise their clients on choice of entity still consider the taxation of these hybrids unpredictable due to the dearth of IRS guidance and the failure of the Internal Revenue Service Code itself to address the unique characteristics of these entities. As the Congressional Research Service pointed out, Congress to date has not enacted any Code sections specifically on these entities.[1] There has been a proliferation of these business forms in recent years; this explosive growth has been noted by many commentators.[2] Since 1996, LLCs have grown at the rate of approximately 23 percent per year, according to the Joint Committee on Taxation.[3] Approximately 1,465,000 such entities filed partnership returns in 2005.[4] The latest IRS statistics show that this number grew to 1,969,446 by 2009, with LLCs making up 62.2 percent of all partnerships and surpassing all other entity types for the eighth consecutive year.[5]

Despite the growth in theses entity types, until recently, the IRS had failed to address key LLC tax issues, such as material participation by LLC members for purposes of the passive loss limitations and the self-employment tax on LLC members. However, the courts have forced the IRS's hand on the material participation issue and recently-issued proposed regulations clarify and change the "limited partner interest" test from a focus on limited liability to a determination based on the member's right to manage the entity.[6]

After Gregg[7], the first major case to address material participation by an LLC member, it was nine years before another LLC material participation case emerged from the courts. In the last three years, the courts have spoken and they are clear. The IRS may not presumptively treat LLC members as "limited partners" for purposes of the material participation tests of Code §469(h)(2). (See Garnett,[8] Hegarty,[9] Thompson,[10] and Newell[11]). This Code subsection treats losses from an "interest in a limited partnership as a limited partner" as presumptively passive. As a result, taxpayers classified as "limited partners" may prove material participation only by meeting one of three more restrictive tests contained in Reg. § 1.469-5T(a) instead of being able to use all seven tests listed in that section. The IRS's limited partner restriction is contained in Reg. § 1.469-5T(e)(2) of the 1988 Temporary Regulations. The Courts have refused to apply the IRS limited partner regulation to LLC members and instead have developed a rule that the material participation of an LLC member is properly determined with reference to any of the seven tests listed in Treas. Reg § 1.469-5T(a).

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[1] Mark P. Keightley, *Business Organizational Choices: Taxation and Responses to Legislative Changes* 9 (2009).
[2] Robert R. Keatinge, *Plumbing and Other Transitional Issues*, 58 Bus. Law. 1051 (2003). Larry E. Ribstein, *Litigating in LLCs*, 64 Bus. Law. 739 (2009). Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 Berkeley Bus. L. J. 263 (Fall 2008). Symposium, *Entity Rationalization: What Can or Should Be Done About the Proliferation of Business Organizations?*, 58 Bus. Law. 1003 (2003).
[3] Staff of J. Comm. of Tax'n, Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity*, JCX-48-08, 8 (2008).
[4] *Id.* at 12.
[5] Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2005*, 27 I.R.S. Stat. of Income Bull. 2, 73 (Fall 2007).
[6] Dept. of Treas. *I.R.S Notice of Proposed Rulemaking: Passive Activity Losses and Credits Limited*, 76 Fed. Reg. 72875 (Nov. 28, 2011).
[7] Gregg v. United States, 186 F. Supp. 2d 1123 (D. Ore. 2000).
[8] Garnett v. Comm'r, 132 T.C. 368 (2009).
[9] Hegarty v. Comm'r., T.C. Summary Opinion 2009-153 (2009).
[10] Thompson v. United States, 87 Fed. Cl. 728 (2009).
[11] Newell v. Comm'r, T.C. Memo 2010-23 (T.C. 2010)

It took five cases in total to move the IRS off its position that LLC members should be presumptively treated as limited partners. Speaking at an AICPA conference in Washington in late 2009, Dianna Miosi, former Branch 1 Chief in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) said, "The Service is under tremendous pressure right now to deal with that issue, and I think this is the time, given the recent string of losses on this case, that the Service is going to have to address that…I think probably within the next year we are going to see some guidance in that area."[12] After that statement was made, it took the IRS two years to promulgate its new rules. In the meantime, LLCs have been facing record losses.[13] This increase in losses will no doubt result in increased controversies with the IRS over passive loss deductions by LLC members, and both the IRS and taxpayers will benefit from a workable set of material participation rules going forward.

This paper explains the approach the IRS has taken in the proposed new regulations on the definition of a limited partnership interest as applied to LLC members. It also explains the various Court rulings on material participation by LLC members which led to the regulation change and addresses the related issue of the self-employment taxation of these taxpayers. Finally, the paper makes some observations about the direction the passive loss limitation debate will move in under the new regulatory scheme.

Early Federal Taxation of Hybrids

Limited liability companies first emerged as recognized entities in 1977, when Wyoming allowed this form of business organization.[14] The IRS waited until 1988 to issue a specific ruling on the tax treatment of these entities. For many years after the inception of the first LLCs, the IRS took the position that an organization would be taxed as a corporation if it had the major characteristics of a corporation.[15] On September 18, 1988, the IRS issued a Revenue Ruling[16] in which it announced that any Wyoming LLC would be treated as a partnership. This ruling was the impetus for other states to pass LLC legislation. By 1997, all 50 states and the District of Columbia had LLC laws on their books.[17]

The state law development of hybrid entities has continued apace and has resulted in a flexible approach that allows LLC members to retain limited liability while having the right to participate in management of the entity. [18] A discussion of state law development on hybrid entities is beyond the scope of this article. However, it is instructive to consider that while the uniform partnership laws and state legislation continue to reflect steady development of the law on hybrid entities, the federal tax laws do not.

[12] David D. Stewart, *IRS Official Expects Guidance on Passive Activity Loss Rules*, 2009 Tax Notes Today 206-2 (October 28, 2009).
[13] In 2008, LLC losses were $305.2 billion compared to $191.3 billion in 2007, larger than the combined losses, $123.8 billion, for both general and limited partnerships. Wheeler and Shumofsky, *supra* note 5.
[14] Larry E. Ribstein, *The Emergence Of The Limited Liability Company*, 51 Bus. Law. 1 (November, 1995).
[15] Keightley, *supra* note 1.
[16] *See* Rev. Rul. 88-76, 1988-2 C.B. 360.
[17] Ellen Legel, Kelly Bennett, and Michael Parisi, *The Effects of Tax Reform on the Structure of U.S. Business* 65 I.R.S Stat. of Income Bulletin (2003).
[18] For a detailed discussion of state law treatment of participation and the loss of limited liability, see Sheldon I. Banoff and Richard M. Lipton., *Passive Losses, LLCs and LLPs—Two Courts Reject the Service's Attempt to Limit Losses,* 111 J. Tax'n 206 (October 2009).

In 1997, the IRS issued final regulations, known as the "check-the-box" regulations, which allow companies to elect how they will be taxed by checking the box on Form 8832.[19] A single-owner LLC can elect to be taxed either as a corporation or as a sole proprietorship while an LLC with two or more members can elect to be taxed as either a partnership or as a C corporation.[20] Most LLCs elect to be treated as partnerships for tax purposes.[21]

As observed by the Congressional Research Service, the Internal Revenue Code has no section pertaining directly to LLCs.[22] As a result, many LLCs are by default subject to the IRS's partnership rules, including those restricting passive activity losses, which are discussed below.

MATERIAL PARTICIPATION STANDARDS OF SECTION 469

Section 469 of the Internal Revenue Code disallows the deduction of a passive activity loss.[23] I.R.C. § 469(d)(1) defines the term "passive activity loss" as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities for that year. The rule disallows the use of net passive losses to offset nonpassive income from other sources. A passive activity is any activity "which involves the conduct of any trade or business" and "in which the taxpayer does not materially participate."[24]

The material participation standard is set forth in I.R.C. § 469(h)(1) and requires that a taxpayer be involved in the operations of the activity on a "regular, continuous, and substantial" basis.[25] With very limited exceptions in the regulations, a limited partner is not [Emphasis added] treated as materially participating in an activity in which the partner holds a limited partnership interest.[26] The IRS's long-standing interpretation of the limited partnership restriction in I.R.C. §469(h)(2) is found in §1.469-5T(e)(1) and (2) of the Temporary Income Tax Regulations. Treas. Reg. §1.469-5T(e)(1) states that "…an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

(i)The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership;[27] and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest."[28]

In effect, a limited partner's interest is per se passive. As LLCs gained in popularity and the IRS had to evaluate their loss claims, it simply applied this limited partner analysis to LLC members and clung to this position for many years.

The language of I.R.C. § 469(h)(2) contemplated that the IRS would add exceptions to the limited partner treatment in its regulations, stating, in pertinent part, "Except as provided in regulations [Emphasis added], no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." However, those exceptions were very narrowly drawn by the IRS in the 1988 version of Treas. Reg. §1.469-

[19] Treas. Reg. § 301.7701-3 (2009).
[20] Keightley, *supra* note 1 at 8.
[21] *Id*. at 9.
[22] *Id.*
[23] I.R.C. § 469(a)(1).
[24] I.R.C. § 469(c)(1).
[25] I.R.C. § 469(h)(1).
[26] I.R.C. § 469(h)(2).
[27] Temp. Treas. Reg. § 1.469-5T(e)(1)(i) (2001).
[28] Temp. Treas. Reg. § 1.469-5T(e)(1)(ii) (2001).

5T(e)(2), (which remains in effect until the proposed regulations are finalized).[29] That section provides that a taxpayer who is a limited partner is treated as having materially participated in an activity only if the taxpayer meets one of following three material participation tests contained in the regulations: (a) the taxpayer participated in the activity for more than 500 hours during the taxable year, (b) the taxpayer materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the taxable year; or (c) the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years preceding the taxable year. These standards represent three of the usual seven tests for material participation contained in § 1.469-5T(a) of the Regulations, specifically numbers (1), (5), and (6) below.[30]

Generally, the passive loss regulations provide that an individual will be treated as materially participating in an activity for purposes of I.R.C. § 469 if:

(1) The individual participates in the activity for more than 500 hours during such year;
(2) the individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
(3) the individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
(4) the activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
(5) the individual materially participated in the activity for any 5 taxable years (whether or not consecutive) during the 10 taxable years that immediately precede the taxable year;
(6) the activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year; or
(7) based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.[31]

1988 Temporary Regulations Focus on Liability Issue

The regulations designate a business interest as a "limited partnership interest" in two circumstances.[32] The first rule states that if an interest is designated as a limited partnership interest in the limited partnership agreement or in the certificate of limited partnership, it will be considered a limited partnership interest under the regulations without regard to whether the

[29] These newly proposed regulations are at Prop. Treas. Section §1.469-5(e)(4).
[30] Temp. Treas. Reg. § 1.469-5T(e)(2)(2) (2001).
[31] Temp. Treas. Reg. § 1.469-5T(a)(1) - (7) (2001). Temp. Income Tax Reg., 53 Fed. Reg. 5725 (1988).
[32] Temp. Treas. Reg. § 1.469-5T(e)(3) (2001).

liability of the holder of the interest is limited under the applicable State law.[33] The second rule provides that if the liability of the holder of the interest is limited to a determinable fixed amount (e.g. the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership) under the law of the State in which the partnership is organized, then the interest will be treated as a limited partnership interest under the regulations.[34] In short, under the first rule, the characterization of the interest in the limited partnership agreement or certificate controls. Under the second rule, state law as to limited liability controls. It should be noted that Treas. Reg. §1.469-5T(e)(3)(ii) provides an exception for dual interests held by a partner. If a taxpayer holds both a limited partnership interest and a general partnership interest in the same partnership, the limited partner restrictions will not apply, and the participation of the dual partner will be judged under the standard seven material participation tests. As authors Sheldon I. Banoff and Richard M. Lipton note in their analysis, "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 a general partner in the same partnership."[35]

'Temporary Regulations' Not Updated for Many Years

The I.R.C. § 469 regulations on material participation were promulgated in February 1988, over 23 years ago,[36] before LLCs and LLPs were in wide use. On September 18, 1988, seven months after the temporary rules were released, the IRS issued Revenue Ruling 88-76,[37] in which it ruled that any Wyoming LLC would be treated as a partnership. The 1988 temporary regulations do not mention LLCs or LLPs. Thus, there is no way to know whether the IRS was considering its ruling position on the appropriate status for hybrid entities at the same time it was working on the temporary material participation regulations.

These temporary regulations were not subject to expiration because they were released shortly before Congress changed the law to require the expiration of temporary regulations three years after release. Nine months after their release, Congress added Section 7805(e) to the Code, effective November 20, 1988, which requires that all temporary regulations must be finalized or reissued within three years after the date of issuance or they will expire.[38] While Congress realized that temporary regulations should not exist forever, it failed to make the rule retroactive. As a result, any regulations issued before November 20, 1988, the effective date of that Code section, can exist as temporary regulations in perpetuity with the force of law.

After its recent court losses, the IRS included an update to the temporary regulations on material participation by limited partners in its Priority Guidance Plans for the last three cycles, 2009-2010, 2010-2011, and 2011-2012.[39] With the 2011 release of proposed regulations on the

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[33] Temp. Treas. Reg. § 1.469-5T(e)(3)(i)(A) (2001).
[34] Temp. Treas. Reg. § 1.469-5T(e)(3)(i)(B) (2001).
[35] Banoff and Lipton, *supra* note 18, at 206
[36] T.D. 8175, 1988-1 C.B. 191
[37] This ruling first appeared in 1988-38 I.R.B. 1.
[38] P.L.100-647, § 6232(a), added subsections (e) and (f) to I.R.C § 7805, effective for any regulation issued ten or more days after November 10, 1988.
[39] Dept. of Treas.. "Guidance under §469 relating to material participation," 2009-2010 Priority Guidance Plan (November 24, 2009). Dept. of Treas.. "Regulations under §469(h)(2) concerning limited partners and material participation," 2010-2011 Priority Guidance Plan (December 7, 2010). Dept. of Treas.. Regulations under §469(h)(2) concerning limited partners and material participation, 2011-2012 Priority Guidance Plan (September 2, 2011).

subject, the much maligned temporary regulations may finally be put to rest. Until the proposed regulations are finalized, however, the temporary regulations are still technically in effect.[40]

The Self-Employment Tax and Material Participation Connection, IRS Punts

If an individual satisfies the requirements of a participation standard under any other provision of the Code, it is not taken into account in determining whether that individual materially participates in an activity for purposes of the passive activity rules.[41] In the explanation of the new proposed regulations, the IRS specifically states that "…the rules concerning an interest in a limited partnership in the proposed regulations are provided solely for purposes of section 469 and no inference is intended that the same rules would apply for any other provisions of the Code requiring a distinction between a general partner and a limited partner."[42] The IRS made this statement because it did not extend the new limited partner analysis for the passive loss rules to cover the determination of the self-employment tax liability of LLC members. As explained below, many observers were hoping the IRS would address the regulatory uncertainty regarding LLC members' liability for self-employment tax and the passive loss rules at the same time in order to come up with a uniform standard. Instead, the IRS specifically disclaimed any connection between the new passive loss rules and the self-employment tax issue.

IRS's Missed Opportunity

Although the passive loss regulations specifically dismiss the applicability of material participation in other contexts, the continuing debate on the tax treatment of limited partners and LLC members for self-employment tax purposes is relevant to an analysis of the problems facing members of these entities under the passive loss rules.[43]

The tax imposed under I.R.C. §1401 on the net earnings from self-employment under the Self-Employment Contributions Act (the "SECA" tax) has been a source of much confusion and much discussion regarding its application to LLC members.[44] Under the SECA rules, a general partner is subject to self-employment tax on the partner's distributive share of income or loss from any trade or business carried on by the partnership. Limited partners, however, are treated differently under I.R.C. §1402(13). Under this provision, taxpayers who hold limited partner status under State law are only subject to self-employment tax to the extent they receive

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[40] Prop. Reg. §1.469-5(e)(4). *See also* Dept. of Treas., *supra* note 6 at 72877.

[41] Temp. Treas. Reg. § 1.469-5T(b)(2)(i) (2001). "Participation satisfying after the date which is 10 days after 11/10/88.standards not contained in section 469. Except as provided in section 469(h)(3) and paragraph (h)(2) of this section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder."

[42] Dept. of Treas., *supra* note 6 at 72876.

[43] For a discussion of the relationship between the passive loss rules and the self-employment tax rules for members of limited liability companies, *see* Audrey Ellis and Jeffrey Rosenber, P*otential Implication of Recent Sec. 469 Court Decisions for Self-Employment Tax Rules*. 41 The Tax Adviser 457 (July 2010).

[44] Patricia E. Dilley, *Breaking the Glass Slipper – Reflections on the Self-Employment Tax*, 54 Tax Law. 65 (2000). Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is It Time For a Uniform Standard?*, 17 Va. Tax Rev. 811 (1998).

guaranteed payments. Thus, a limited partner's distributive share of partnership income or loss is excluded from self-employment tax.

In 1997, the IRS issued proposed regulations that defined which partners of a federal tax partnership would be considered limited partners for purposes of the SECA tax.[45] The proposed rules provided three functional tests for determining if a taxpayer would be considered a "limited partner" for purposes of the SECA tax. An individual would be treated as a limited partner unless the individual (1) has personal liability for the debts of or claims against the partnership; (2) has authority to contract on behalf of the partnership under the state law where the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.[46] The rules applied to all entities classified as partnerships for federal tax purposes regardless of the state law characterization of the entity.[47] The rules also provided that if substantially all of the activities of a partnership involved the performance of professional services, such as health, law, engineering, architecture, accounting, actuarial science, or consulting, any partner who performs the services would not be considered a limited partner, and all of the partner's profits would be subject to self-employment tax.[48]

The proposed rules' restrictive definition of limited partners and the required SECA taxation of service partners and LLC members led to an outcry that provoked Congress to place a moratorium on the regulations as part of the Tax Relief Act of 1997.[49] The Act prevented Treasury from issuing or making effective any regulations relating to the definition of "limited partner" for self-employment tax purposes before July 1, 1998. The regulations and the moratorium were highly criticized,[50] and the IRS backed off its position and took no further action on the regulations. In fact, as the Joint Committee has noted, no regulations on the SECA tax issue have been proposed or finalized since that time.[51]

The language below from the IRS's 1997 Notice of Proposed Rulemaking is ironic, considering that it took the IRS over 20 years to update the passive activity loss rules for LLC members and that it still has not published new guidance on SECA taxation for these taxpayers.

> The need for a functional approach results not only from the proliferation of new business entities such as LLCs, but also from the evolution of state limited partnership statutes. When Congress enacted the limited partner exclusion found in section 1402(a)(13), state laws generally did not allow limited partners to participate in the partnership's trade or business to the extent that state laws allow limited partners to participate today.[52]

This view is echoed by the Joint Committee on Taxation in its 2008 Report on Small Business and Choice of Entity,[53] which states, "Some state laws governing limited partnerships, meanwhile, have changed to permit limited partners to perform services for the partnership or to participate in the management of the partnership's business, so limited partner status is no longer a workable proxy for determining that a partner does not have significant labor income from the

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45 Dept. of Treas., *I.R.S. Notice of Proposed Rulemaking*. 62 Fed. Reg. 1702 (Jan. 10, 1997).
46 *Id.*
47 *Id.*
48 *Id.*
49 Taxpayer Relief Act of 1997. Pub. L. No. 105-34 § 935 (1997).
50 Emily Field, *The Stealth Moratorium on the 'Stealth Tax' on Limited Partners* 81 Tax Notes 868 (1998). Dan R. Mastromarco, *Why Small Businesses Are Upset About Sec. 1402(a)(13) & Other Trivia* 75 Tax Notes 707 (1997).
51 Staff of J. Comm. on Tax'n, *supra* note 3, at 56.
52 Dept. of Treas. I.R.S. Notice of Proposed Rulemaking, *supra* note 44.
53 J. Comm. on Taxation, *supra* note 1, at 64.

partnership…Thus, the employment tax law in force today does not provide clear guidance to LLC owners."[54]

Renkenmeyer Case

While IRS officials have stated that taxpayers can simply rely on the proposed regulations,[55] the Tax Court has revived the rules in the stalled proposed regulations, taking an aggressive stance against partners who perform services for their partnerships and attempt to avoid self-employment tax by taking advantage of the limited partner exclusion.[56] In Renkemeyer, the Tax Court found that the individual partners' distributive share of a law firm's net business income from legal services was subject to self-employment tax. The firm was a limited liability partnership and the partners had sought to take advantage of the limited partner exclusion in Code Sec. 1402(a)(13). The Court rejected the Petitioners' position, noting that the exclusion was intended to cover investors in the business, not active participants who perform the basic service business of the partnership. The Court noted that all of the law firm's revenues were derived from legal services performed by the Petitioners in their capacities as partners.[57]

The Problem of Inconsistent Positions

Attorney Thomas R. Levy, in a 2005 article on the treatment of LLCs under the SECA rules, has suggested that the position an LLC member takes with respect to material participation for purposes of the passive loss rules should control the LLC member's position for material participation in the context of the SECA tax.[58] He concludes that "to achieve as much simplicity as possible under the circumstances, material participation should have the same meaning as that defined under the passive activity loss rules of I.R.C.§469…"[59] As Banoff and Lipton observed in their analysis of the Garnett and Thompson cases, while taxpayers seek to avoid "limited partner" status for purposes of the passive loss limitations of I.R.C.§469(h), they may desire to be treated as limited partners under I.R.C.§1402(13), thus avoiding self-employment taxes on their distributive share.[60] Banoff and Lipton dismiss the idea of conforming the definition of "limited partner" for the passive loss rules to the definition of that term for self-employment tax rules, stating that the passive loss and self-employment rules "do not serve the same purposes and are derived from different legislative concerns."[61] However, uniform treatment would result in more certainty for these taxpayers and would reduce the administrative burdens on the IRS in monitoring inconsistent positions. Developing consistent material participation standards for purposes of both the SECA tax and the passive loss rules that specifically address the treatment of LLC and LLP members would have resolved these long-standing disparities, as many

[54] *Id*.
[55] Amy S. Elliot, *Taxpayers Can Rely on Limited Partner Employment Tax Regs, IRS Official Say*, Tax Notes Today (January 15, 2010).
[56] Renkemeyer, Campbell & Weaver, LLP v. Comm'r., 136 T.C. 137 (2011).
[57] *Id.*
[58] Thomas R. Levy, *The Role of Limited Liability in Determining Self-Employment Income Tax: The Continuing Conundrum of the LLC Member*, 2005 Tax Notes Today 114-38, at note 9 (June 15, 2005).
[59] *Id.*
[60] Banoff and Lipton, *supra* note 18 at 216.
[61] *Id*. at 217.

commentators have observed.[62] In a recent article, one commentator has proposed how Congress or the Treasury could resolve the LLC member classification issue with one rule for both Section 469 and Section 1402[63] by classifying as a limited partner any LLC individual owner with limited liability "who is not engaged in the entity's conduct of a trade or business."[64] While the IRS has moved in this direction in the proposed passive loss regulations, no attempt at conformity with the SECA tax has been made. Despite the emerging consensus in the practitioner community and the pleas in the literature, the IRS specifically warned in its Notice of Proposed Rulemaking that the general/limited partner distinction in the proposed passive loss regulations does not necessarily extend to other areas of the tax law—read, the self-employment tax rules.[65] The Notice of Proposed Rulemaking explains the distinction in this way, stating that the rules in the new proposed regulations are "based on the purposes for which section 469 was enacted, and the manner in which the provision is structured and operates within the Code."[66]

PASSIVE LOSS CASES: TAXPAYERS 4, IRS 0

Courts Took the Lead

Despite the IRS's own evidence of the increase in partnership returns attributable to LLCs, IRS Chief Counsel did not keep pace with the guidance needed to address the passive activity issues facing the owners of these entities until after the Courts stepped in to fill the void. The evolution of Court cases on material participation by LLC members shows how the IRS arrived at its decision to abandon the 1988 temporary regulations' focus on limited liability and instead focus on an LLC member's right to manage the entity.

For the first 12 years after the temporary regulations were released, no Court addressed the issue of how to apply the I.R.C. § 469 material participation rules to LLCs and LLPs. Then came the Gregg case.[67] In that District Court case, Judge Ann Aiken staked out a bold position in a case of first impression—that the temporary regulations for testing material participation by limited partners are "obsolete" when applied to LLCs and their members.[68] Nine years later, in 2009, three similar cases were decided within four months of each other, two from the Tax Court (Garnett and Hegarty)[69] and one from the Court of Federal Claims (Thompson).[70] All three cases essentially have the same holding—that the IRS was incorrect in presumptively treating members of LLCs and LLPs as limited partners under the restricted material participation tests of the temporary I.R.C.§ 469 regulations.

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[62] *See*, for example, Steward Karlinsky, *Self-Employment Taxes and PALs: The Case of LLCs*, Tax Notes Today (Sept. 26, 2011).
[63] Claire Nash, *Ending De Facto Self-Employment Tax Holiday for LLC Members*, Tax Notes Today (Sept. 15, 2010).
[64] *Id.*
[65] Dept. of Treas. I.R.S Notice of Proposed Rulemaking, *supra* note 44.
[66] *Id.* at Explanation of Provisions.
[67] Gregg, *supra* note 7.
[68] "According to defendant, for Section 469 purposes, all members of an LLC will be treated as limited partners of the LLC that is taxable as a partnership, because of their limited liabilities under Oregon law. Plaintiffs argue that the limited partnership test, as set forth in Temporary Treasury Regulation section 1.469-5T(e)(3)(i)(B) and recited by defendant, 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." *Id.* at 1128.
[69] Garnett, *supra* note 8. Hegarty, *supra* note 9.
[70] Thompson, *supra* note 10.

Gregg Distinguishes New Business Entity

In Gregg, the plaintiff was a member of (Cadaja) an alternative medicine management company. The business was organized as a limited liability company under Oregon law in 1994 and was taxed as a partnership under federal law. The plaintiff worked approximately 100 hours for the company during the tax year at issue. He did not receive compensation for his services because he did not want to take any money out of the new business. The IRS audited the LLC's 1994 tax return and disallowed plaintiff's characterization of a flow-through loss as an ordinary loss. Instead, the Service re-characterized the loss as a passive activity loss, disallowed the deduction, and assessed interest and penalties.

The case went to the District Court on summary judgment. The plaintiff argued that he should be treated as a general partner under the regulations since, under Oregon law, there was no restriction on his participation in management.[71] The government argued that federal law preempted the Oregon law in this context, and, thus, all members of an LLC should be treated as limited partners of an LLC that is taxable as a partnership because of their limited liability under Oregon law.[72] Specifically, Temp. Treas. Reg. §1.469-5T(e)(3)(i)(B) provides that for purposes of I.R.C. §469, a partnership interest is treated as a limited partnership interest if "[t]he liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount...." The government's argument can be summarized as follows: Oregon law should be ignored on the issue of the ability of an LLC member to participate in management, but Oregon law on limited liability should be controlling.

The Court further examined Oregon law and determined that the government's position could not be reconciled with the State law requirement that limited partnerships have at least one general partner. If the government treats all LLC members as limited partners for federal tax purposes, then the entity does not satisfy the State requirement that an entity have at least one general partner.[73] In addition, the Court observed that LLC members retain their limited liability despite their participation in the management of the LLC while a limited partner cannot, "by definition," participate in the management.[74] The Court concluded that the higher standard of material participation for limited partners should not be applied to the plaintiff, and that, instead, the plaintiff should be evaluated under all seven of the material participation tests set forth in Temporary Treasury Regulation §1.469-5T(a)(1)-(7). Under this analysis, the Court found that plaintiff had materially participated and it allowed the ordinary losses.[75]

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[71] "Oregon State law distinguishes limited partner status from general partner status based on a taxpayer's "control," rather than liability, of a business entity. See ORS 70.135." Gregg, *supra* note 7, at 1127.

[72] "Defendant argues, however, that plaintiff should be treated as a limited partner. Although Cadaja was an LLC formed under the Oregon Limited Liability Company Act, for federal taxation purposes, and more relevantly, for Section 469 purposes, Oregon law is preempted and does not apply, except as otherwise directed by the provisions of Section 469 and its regulations." *Id.* at 1128.

[73] "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 a treatment does not satisfy the requirement of 'at least one general partner.'" *Id.*

[74] *Id.*

[75] The Court also allowed the grouping of plaintiff's LLC activities with the personal service activities of his C Corporation but that discussion is beyond the scope of this article. *Id.* at 1131.

Commentators have noted that the Gregg Court did not find the temporary regulations incorrect or invalid.[76] It merely refused to extend the regulations on limited partners to cover all LLC members.

Tax Court Cases Apply General Material Participation Tests

The U.S. Tax Court, in one regular opinion, Paul D. Garnett, et ux. v. Commissioner 132 T.C. No. 19 (2009), one memorandum opinion, Lee E. Newell, et ux. v. Commissioner, TC Memo 2010-23, and one summary opinion, Sean K. Hegarty, et ux., v. Commissioner, T.C. Summary Opinion 2009-153, established its clear position that it is improper for the IRS to automatically treat LLC and LLP members as limited partners under the I.R.C. §469 material participation regulations. The Garnett opinion was issued on June 30, 2009 and the Hegarty opinion followed on October 6, 2009. The Newell case was decided later, in February of 2010. In all three cases, the Tax Court held that LLC members' activities may be judged under any of the seven general material participation tests of the temporary regulations.

In Garnett, the taxpayers held interests in seven LLPs and two LLCs that were engaged in agribusiness operations. They also held interests in tenancies in common, which were presumptively treated as partnerships under Iowa law. Most of these interests were held indirectly through five, separate limited liability companies. The taxpayers reported income and expenses as partners and their K-1s for each LLP identified the relevant holding LLC for Mr. Garnett as a "limited partner." The LLP agreements provided that each partner would actively participate in the control, management, and direction of the partnership's business and further stated that no partner would be liable for the partnership's debts or obligations unless otherwise required by Iowa law. The LLCs also were organized and operated under Iowa law. The taxpayers reported income and expenses on partnership returns and each LLC identified the relevant holding LLC or Mr. Garnett as a "limited liability company member." The LLCs were to be managed by a manager, voted on by a majority of the members, who would have exclusive authority to act for the company. (The petitioners were not managing members of the two LLCs that were not holding LLCs.)

On cross-motions for partial summary judgment, the parties requested a ruling as to whether the Garnetts' interests were subject to the rule of I.R.C. § 469(h)(2), which treats losses from an "interest in a limited partnership as a limited partner" as presumptively passive. The Court held that because the Garnetts did not hold their interests in the LLPs or LLCs as "limited partners," these interests were not subject to the limited partnership rule of I.R.C.§ 469(h)(2). It also held that the tenancies in common were not interests in limited partnerships.

Instead, the Court found that the Garnetts' interests should be tested under the general partner exception of Treas. Reg. §1.469-5T(e).[77] Treasury Reg. § 1.469-5T(e)(3)(ii) provides an exception for dual interests held by a partner. If a taxpayer holds both a limited partnership interest and a general partnership interest in the same partnership, the limited partner restrictions will not apply and the participation of the dual partner will be judged under the standard seven tests. Although the Court did not find that the Garnetts technically held dual interests, it concluded that the general partner analysis should be applied to LLC and LLP members because of their ability to participate in the activity without losing limited liability.

[76] "…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." *Id.* at 1129. *See also* Banoff and Lipton, *supra* note 18, at 209.
[77] Garnett*, supra* note 8.

The IRS argued that the “sole relevant consideration” is that petitioners enjoyed limited liability with respect to their ownership interests. Because of this limited liability, the IRS found each of the Garnetts’ LLP and LLC interests to be limited partnership interests under the temporary regulations. The Court noted that, “[a]ccording to respondent [IRS], this ends the matter.”[78] The Court found this approach faulty, stating that “the operative condition for applying section 469(h)(2) is not simply that there be an “interest in a limited partnership” but an “interest in a limited partnership as a limited partner”.[79] On the other hand, the Garnetts did not succeed in urging that the term “limited partner” cannot encompass any LLP or LLC member because those entities are not classified as limited partnerships under applicable State law.

The Court found the general partner analysis relevant because members of LLPs and LLCs, unlike limited partners in a State law limited partnerships, are not barred by State law from materially participating in the entities' business. Therefore, the Court reasoned, the IRS was wrong to presume that the members do not materially participate. The Court concluded that, in the case of LLP and LLC members, it is necessary to examine the facts and circumstances to ascertain the nature and extent of their participation. The Court held that this factual inquiry is appropriately made under the seven general tests for material participation under the regulations.

The Tax Court in Garnett, like the Gregg Court, pointed out that Congress could not have had LLPs or LLCs in mind in 1986 when it enacted the limited partnership exception in I.R.C. § 469(h)(2).[80] It further noted that the temporary regulations promulgated in 1988 make no explicit reference to LLPs or LLCs. Therefore, although the Court did not invalidate the temporary regulations, it “simply decline[d] to fill any gap therein to reflect respondent's litigating position in this case.”[81]

The Garnett case was brought up on a motion for partial summary judgment.[82] The Court granted the petitioners' motion for partial summary judgment[83] and the case was eventually settled.

TC Summary Opinion Echos Garnett Rule

The Tax Court faced the LLC issue again three and one-half months after deciding Garnett, this time in a case brought under the “S” case procedure.[84] In Sean K. Hegarty, et ux., v. Commissioner, T.C. Summary Opinion 2009-153 (10/06/2009), the Court reiterated its new rule: LLC members are not per se limited partners and they should have available to them any of the seven material participation tests.

The pro se taxpayers, both employed elsewhere, formed Blue Marlin, L.L.C. (Blue Marlin), a Maryland limited liability company. The taxpayers each owned a 50-percent interest in the LLC. Blue Marlin was organized to conduct a charter fishing activity. The petitioners maintained a written log of the amount of time they each participated in the business, but that log was lost during Petitioners' move from the Washington, D.C. area to Florida. Using receipts for expenditures made in connection with the business, Petitioners reconstructed the amount of time

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[78] *Id*, at 19.
[79] *Id*.
[80] L.L.P.s did not come into existence until 1991. Alan R. Bromberg and Larry E. Ribstein. *Bromberg and Ribstein on Partnership*, § 1.01(b)(5) (1998).
[81] Garnett, *supra* note 8, at 381.
[82] *Id*.
[83] *Id.* at 383.
[84] I.R.C. § 7463.

they participated in the business during 2003, the year in question. The evidence presented indicated that Petitioners' participation in the business exceeded 100 hours during 2003.

Blue Marlin was taxed as a partnership, and Petitioners reported a net loss of $64,578 from the LLC. The IRS disallowed the loss deduction. According to IRS, because the business was conducted through a limited liability company, Petitioners should be treated as limited partners in considering whether they materially participated in the business. The IRS found that the Petitioners did not materially participate in the business because they did not establish that their participation during 2003 exceeded 500 hours under Temp. Treas. Reg. §1.469-5T(a)(1), one of the three tests available to limited partners.

With little discussion, the Court stated, "In Garnett we found the Commissioner's reliance upon section 469(h)(2) to be misplaced and held that the material participation of a taxpayer who participated in a business conducted through a limited liability company is determined with reference to any of the seven tests listed in section 1.469-5T(a)(1) through (7), Temporary Income Tax Regs., supra."[85] While "S" cases cannot be appealed or used as precedent,[86] the Hegarty case further shows that the Tax Court had settled on its rule.

Newell Case Uses General Partner Exception

The most recent Tax Court opinion on material participation by LLC members came in February 2010 in the Newell case. In that case, the Tax Court held that an LLC managing member's losses from his 1/3 interest in the LLC were not presumptively passive under Code Sec. 469(h)(2).[87] The taxpayer was required by the LLC operating agreement to participate in the management of the entity. The Court noted that members of a California LLC can participate directly in management, but they also enjoy limited liability for company debts and liabilities under California law.[88] Therefore, the Court found that the members of a California LLC more closely resemble general partners than limited partners. This is particularly true with respect to petitioner husband, said the Court, who was the managing member of the LLC. In that capacity, he managed the day-to-day operations of the company, functioning just as a general partner would function in a limited partnership.[89] The Court concluded that the petitioner qualified for the Temp. Reg §1.469-5T(e)(3)(ii) general partner exception.[90]

Claims Court Says IRS Exceeded Its Authority

One has only to read the first sentence of the opinion in Thompson v. U.S. to get a sense of where the Court is going: "The nub of this case is whether the government is collecting more taxes than written law and regulation allow"[91]. In short, the tax code and the applicable regulations under I.R.C. § 469, which do not mention LLCs, cannot be read to "transfigure" the Plaintiff's member interest in his LLC into one of a limited partnership.[92]

[85] Hegarty, *supra* note 9, at 8.
[86] See I.R.C. § 7463(b) "Finality of decisions. A decision entered in any case in which the proceedings are conducted under this section shall not be reviewed in any other court and shall not be treated as a precedent for any other case."
[87] Newell, *supra* note 11.
[88] *Id.*, at 159.
[89] *Id.*, at 158.
[90] Hegarty, *supra* note 9.
[91] Thompson, *supra* note 10, at 728.
[92] *Id.* at 729

The case also was one of first impression for the U.S. Court of Federal Claims. The Plaintiff formed Mountain Air Charter, LLC under Texas law and did not elect to be taxed as a corporation. Thus, it reported its federal tax as a partnership. Plaintiff directly held a 99% member interest in Mountain Air and indirectly held the remaining 1% through JRT Holdings, Inc., a Subchapter S corporation. Mountain Air's articles of organization designated Plaintiff as its only manager. On his 2002 and 2003 individual income tax returns, Plaintiff claimed substantial losses from his interest in Mountain Air. The IRS disallowed the claimed losses as passive activity losses with the IRS auditor concluding that because Plaintiff enjoyed limited liability as an LLC member, his interest was identical to a limited partnership interest. The case came to the Court on cross motions for partial summary judgment and took almost two years to be decided.[93] The parties stipulated that if Plaintiff's member interest was found to be a limited partnership interest, then Plaintiff would not be able to demonstrate his material participation in the LLC.

The IRS advanced every argument for treating the LLC member as a limited partner used in the previous cases of Garnett and Gregg and a few more, yet the Court rejected every one of them. Citing Gregg, the Court first dismissed the IRS's argument that Mountain Air was a limited partnership because it was taxed as such. The Court observed that an LLC is not a limited partnership because its members may participate directly in the management of the company and still enjoy limited liability regardless of their respective levels of involvement.[94] Further, the Court found that the plain language of the regulation relied upon by the government from Treas. Reg. § 1.469-5T(e)(3) explicitly requires that the limited partnership interest must be in a business entity that is, in fact, a partnership under state law—not merely taxed as such under the Code.

The Court further determined that even if the Plaintiff's interest was in a limited partnership, it would be considered a general partnership interest under the exception of Treas. Reg. §1.469-5T(e)(3)(ii) because Plaintiff was manager of the operation. Finally, the Court rejected the IRS's insistence that the controlling factor in determining what kind of interest the Plaintiff held was limited liability as contemplated at the original time of enactment of I.R.C.§ 469, in 1986, and at the time of the promulgation of the temporary regulations in 1988. Again, the Court took a common sense approach citing the law on limited partnerships at the time under the Uniform Limited Partnership Act[95] and noted that the basic I.R.C.§469 approach was to focus on the level of participation by a member in a business as the determining factor as to whether the activity would be considered passive.

After a long discussion of Congressional intent in enacting the limited partner rules in I.R.C.§ 469, the Court held that the IRS had overstepped its bounds in trying to extend to LLC members the Code's presumption that limited partners do not materially participate in their limited partnerships.[96] Like the Gregg and Garnett Courts, the Thompson Court refused to allow the IRS to presumptively treat LLC members as limited partners.

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[93] The case was originally assigned to Judge Victor J. Wolski on March 15, 2006. The cross motions were heard on August 2, 2007. Even with only one issue before the Court, after one and one-half years, Judge Wolski had not rendered his decision. As a result, on March 6, 2009, the case was reassigned to Judge Lawrence J. Block, who asked that the case be rebriefed by April 22, 2009. Three months later, Judge Block rendered his decision. See Thompson Case Docket retrieved October 23, 2009 from the PACER website at http://ecf.cofc.uscourts.gov/cgi-bin/DktRpt.pl?102106469278969-L.
[94] Thompson, *supra* note 10, at 732.
[95] *Id*. at 732-33.
[96] *Id.*

IRS Settles Garnett and Acquiesces in Thompson

Action on the Garnett and Thompson cases was suspended before the controversies were fully played out. While Garnett was set down for trial, it ended up being settled without further fact-finding by the Court and was terminated by a Stipulated Decision by Judge Colvin on August 26, 2010.[97] The government filed a Notice of Appeal in the Thompson case on September 21, 2009,[98] but the parties moved to jointly dismiss the Notice of Appeal on December 18, 2009.[99] Then in April 2010, the IRS released an Action on Decision (AOD) in the Thompson case, acquiescing in result only.[100] In the AOD, the IRS noted that the Thompson court was the third court to rule against the position that an interest in an LLC is a limited partnership interest under Treas. Reg. § 1.469-5T(e)(3)(i). The AOD was intended to "get the word out that we're not going to be litigating these cases anymore," according to Dianna Miosi, Special Counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries).[101] The acquiescence was in result only, indicating that the IRS did not necessarily agree with the Court's reasoning, leaving it room to fashion its own approach.

Courts Adopt Management Test for LLC Members

The Courts flatly rejected the IRS's insistence that limited liability should be the controlling factor in determining whether an LLC member should be treated as a limited partner under the material participation rules. Instead, the Judges fashioned a rule loosely based on the general partner exception under the exception of Treas. Reg. §1.469-5T(e)(3)(ii) focusing instead on an LLC member's right to participate in management as the proper inquiry. Not surprisingly, the IRS effectively has adopted this approach in the proposed regulations, explained in more detail below.

Proposed Regulations Reflect Judicial Holdings

On November 25, 2011, the IRS finally issued proposed regulations revising its approach to testing material participation by LLC members for purposes of the passive loss limitations.[102] Under the previous temporary regulations, the IRS had restricted LLC members' ability to use all seven material participation tests by treating them presumptively as "limited partners" because of their limited liability. As urged by the Courts, the proposed regulations eliminate the current regulations' reliance on limited liability as the determining factor and instead adopt an approach that examines an LLC member's right to participate in management of the entity.[103] Under the new rules, if the LLC member has the right to manage the entity "at all times during the entity's taxable year" under state law and under the entity's governing agreement, then the LLC member

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[97] Docket 19987-08, Estate of Klaus A. Dueck, Deceased, Paul Garnett, Personal Representative and Trudy Dueck.
[98] Thompson v. The United States, No. 06-211 T Fed. Cl. (2009). Notice of Appeal filed September 21, 2009.
[99] Federal Claim 06-211 T. A Satisfaction of Judgment was filed on Case 1:06-cv-00211-LB, Document 57, Filed August 17, 2010 with over $1,120,307.19 being refunded to the taxpayer.
[100] Action on Decision 2010-002, 2010-14 I.R.B. (4/5/2010).
[101] Jeremiah Coder, *No Decisions Yet on Coming Material Participation Guidance, IRS Official Says*, 2010 Tax Notes Today 47-2 (March 11, 2010).
[102] Dept. of Treas., *supra* note 6
[103] *Id.* at 72876.

will not be treated strictly as a passive investor.[104] The practical effect of this change is to allow LLC members to use any of the seven material participation tests to avoid the passive loss limitations.

Specifically, the regulations preserve the consistency with the existing statutory language under Code §469(h)(2) by defining the conditions under which an interest in an entity will be treated as an interest in a limited partnership "as a limited partner." The regulations remove the language in Temp. Reg. §1.469-5T(e)(3)(i) and (ii) on limited liability and replace those tests with a two-prong, conjunctive approach as follows:

> (3) Interest in a limited partnership as a limited partner -- (i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), an interest in an entity shall be treated as an interest in a limited partnership as a limited partner if –
> (A) The entity in which such interest is held is classified as a partnership for Federal income tax purposes under § 301.7701-3; and
> (B) The holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement.[105]
> Thus, an LLC member will only be treated as holding a limited partner interest if the member does not have the right to manage.

The proposed regulations also preserve the general partner exception in the temporary regulations[106] for taxpayers holding dual interests.[107] Under the proposed rules, if a taxpayer holds dual interests, the general partner exception applies to both interests.

Significance of the IRS's Management Rights Approach

The approach of the proposed regulations is to focus on an LLC member's "rights to manage" the entity as determined under the law of the jurisdiction in which the entity is organized and under the entity's government agreement. The IRS did not fully explain what it considers "rights to manage" except to say that "rights to manage" include the power to bind the entity.[108] Some practitioners have already called on the IRS to further explain the regulations' concept of "rights to manage."[109]

This focus on "rights to manage" gets the taxpayer past the limited partner presumption, but the taxpayer still must prove actual participation under one of the seven rules. This change should make it easier for members of member-managed LLCs to prove material participation and to avoid the passive loss limitations. In addition, limited partners with management rights may be able to overcome the limited partnership interest presumption if under the revised limited partnership rules of their state and their limited partnership agreement they are allowed to participate in the management of the

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[104] Treas. Prop. Reg. §1.469-5(e)(3)(B).
[105] Treas. Prop. Reg. §1.469-5(e)(3).
[106] Treas. Temp. Reg. §1.569-5T(e)(3)(ii).
[107] The proposed regulations use the same regulation subpart number for the general partner exception that was used in the temporary regulations, Prop. Treas. Reg. §1.469-5(e)(3)(ii).
[108] Dept. of Treas., *supra* note 6 at 72876.
[109] Amy S Elliot, *IRS May Clarify Limited Partner Interest Test in Material Participation Regs*, 2012 Tax Notes Today 7-1. (January 11, 2012).

partnership. True passive investors who are barred from management will continue to be restricted to using only the three material participation tests.

Clarification of Proposed Regulations May Be Needed

One aspect of the proposed regulations has already caused confusion—the second prong of the test that makes reference to the taxpayer's right to manage under state law and the organization's governing agreement. Only six weeks after the IRS released it proposed regulations, the author of those rules, Michala P. Irons, Attorney in Branch 1, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), principal author of the rules, told a practitioner group that clarifications may be needed to further explain the interplay between state law and the LLC operating agreement. [110] Irons told attendees at a BNA Tax Management luncheon in Washington in January 2012 that taxpayers need only meet one part of the "right to manage" test in Prop. Reg. §1.469-5(e)(3)(B) to be treated as a general partner. Thus, taxpayers will not be treated as limited partners if they have the right to manage the entity under either state law or under the entity's operating agreement.[111] However, the IRS still has under consideration the situation where state law includes a right to manage but the entity's operating agreement cuts off that right.[112]

Effective Date

The new rules will take effect only when final regulations are published in the Federal Register.[113] The proposed rules do not allow taxpayers to elect to apply them in advance, according to Irons, but the government may consider retroactive application in the interim.[114] Thus, the IRS could continue to rely on the old analysis of a limited partner interest in examinations until final rules are issued. However, in view of the IRS's court losses and its acquiescence in the Thompson result, it is very unlikely that the IRS will continue to enforce the 1988 temporary regulations. Rather, the IRS could adopt the new rules before they take effect.

The IRS called for public comments on the proposed regulations due on February 27, 2012.[115] As of this writing, no public comments have been submitted. It will be interesting to see how quickly the IRS completes the process of finalizing the regulations and making their new position official. While the new rules have some vague aspects and need further clarification of the concept of "rights to manage" and more direction to taxpayers in situations when the state law on management rights is trumped by an entity's operating agreement, the IRS's new approach is essentially noncontroversial and has been sanctioned by the Courts.

CONCLUSION

The IRS's dramatic shift in policy has taken a long time and has come only after a decisive series of victories by taxpayers in the Courts over the last few years. Some insight into

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[110] *Id.*
[111] Alison Bennett, *Passthrough Entities Test for Limited Partners Under New Rules Looks at 'Right to Manage," IRS Official Says*, BNA Daily Tax Report (January 11, 2012).
[112] Elliot, *supra* note 109.
[113] Treas. Prop. Reg. §1.469-5(e)(4).
[114] Bennett, *supra* note 109.
[115] Dept. of Treas., *supra* note 6.

the delay was given in a 2010 statement from Dianna Miosi, former Special Counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), now a director at PriceWaterhouseCoopers, when she explained that allowing all partners to use all seven material participation tests has been considered by the IRS, but the difficulty is in preserving Code section 469(h)(2)'s presumption on passivity.[116] In the end, that section was preserved by shifting the presumption of limited partner status based on limited liability to a presumption based on the right to manage the entity. Moreover, the IRS, admittedly, could no longer ignore the "significant shift" in state laws as seen in revised model legislation to allow participation in management both for LLC members and for limited partners.[117]

While the problem may be solved for now, the process these regulations have gone through to arrive at a modern view of the taxation of LLC members merits some review. If taxpayers are to comply with rules, they have to understand clearly what those rules are. The vagueness and uncertainty of this area of the tax law and the IRS's failure to update its regulations for 23 years allowed the IRS to apply its I.R.C. §469(h)(2) limited partner rule in such a way to disallow many arguably legitimate LLC losses. Further, the IRS should have seized the opportunity to address the proper treatment of LLC members for self-employment tax purposes as well to resolve the problem of taxpayers' taking inconsistent positions on their limited partner status depending on whether they are faced with SECA taxes or limitations on passive losses. Taxpayers should be able to rely on modern, present-day regulations that accurately reflect prevailing methods of doing business. Instead, for many years before the proposed rules were issued, taxpayers when faced with audits had to initiate costly court actions to resolve important tax issues under out-moded regulatory concepts based on the limited partnership tax shelters of a past era. As one recent commentator has observed, maybe it is time to dispense with the passive loss rules altogether.[118]

With LLC members now able to attempt to prove material participation under any of the seven tests, the fight now moves to the factual arena. We may see the IRS seize upon a new strategy—to more vigorously fight LLC passive loss cases based on recordkeeping and the proof of material participation. However, that discussion is for another day.

[116] Coder, *supra* note 98.
[117] Bennett, *supra* note 109
[118] George S Jackson, *Passive Activity Limitations: Time for a New Paradigm?*, 2011 TNT 206-17 (October 25, 2011).

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