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### Overview

The passive loss rules<sup>1</sup> can have a substantial impact on farmers and ranchers as well as investors in farm and ranch land. Until 1987, it was not uncommon for non-farm investors to purchase agricultural land and incur losses which the investor would then use to offset against the investor’s wage or other income. However, the passive loss rules, enacted in 1986, reduce the possibility of offsetting passive losses against active income.<sup>2</sup> The effect of the rules is that deductions from passive trade or business activities, to the extent the deductions exceed income from all passive activities may not be deducted against other income.<sup>3</sup>

The proper characterization of the loss depends on whether the taxpayer is materially participating in the business.<sup>4</sup> But, I.R.C. §469(h)(2) creates a per-se rule of non-material participation for limited partner interests in a limited partnership *unless the Treasury specifies differently in regulations*. The statute was written before practically all state LLC statutes were enacted and before the advent of LLPs, and the Treasury has never issued regulations to detail how the statute is to apply to these new types of business forms.

The issue of how losses incurred by taxpayers that are members of LLCs (and LLPs) are to be treated under the passive loss rules has surfaced in four recent court opinions three by the U.S. Tax Court (one a full opinion, one a memorandum opinion and one a summary opinion) and one by the U.S. Court of Federal Claims). In the cases, IRS stood by its long-held

position that the per-se rule of non-material participation applies to ownership interests in LLCs because of the limited liability feature of the entity.

### Material Participation Tests - Passive Losses

The key question presented in the cases was whether the taxpayer satisfied the material participation test. As mentioned above, a passive activity is a trade or business in which the taxpayer does *not* materially participate.<sup>5</sup> Material participation is defined as “regular, continuous, and substantial involvement in the business operation.”<sup>6</sup> The regulations provide seven tests for material participation in an activity.<sup>7</sup> The tests are exclusive and provide that an individual generally will be treated as materially participating in an activity during a year if:

- The individual participates more than 500 hours during the tax year;
- The individual’s participation in the activity for the tax year constitutes substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the tax year;
- The individual participates in the activity for more than 100 hours during the tax year, and the individual’s participation in the activity for the tax year is not less than the participation in the activity of anyone else (including

non-owners) for the tax year;

- The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities during the tax year exceeds 500 hours;
- The individual materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the tax year at issue;
- The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years preceding the tax year at issue; or
- Based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year

However, if the taxpayer is a limited partner of a limited partnership, the taxpayer is presumed to *not* materially participate in the partnership's activity, "except as provided in the regulations."<sup>8</sup> The regulations provide an exception to the general presumption of non-material participation of *limited partners in a limited partnership* if the taxpayer meets any of one of three specific material participation tests that are included in the seven-part test for material participation under Treas. Reg. 1.469-5T(a)(1)-(7). Those three tests are:

- The 500 hour test;<sup>9</sup>
- The five out of 10 year test;<sup>10</sup> and
- The test involving material participation in a personal service activity for any three years preceding the tax year at issue.<sup>11</sup>

Thus, the standard of "material participation" for a *limited partner* is higher than that for a general

partner, and the question presented in the case was whether the more rigorous standard for material participation for *limited partners in a limited partnership* under I.R.C. §469(h)(2) applied to the taxpayers (who held membership interests in LLCs and LLPs) with the result that their interests were per-se presumptively passive.

### The Tax Court's Full Opinion<sup>12</sup>

**Facts of the case.** The taxpayers, a married couple residing in Nebraska, owned interests in various LLCs and partnerships that were organized under Iowa law as well as certain tenancy-in-common interests that were all engaged in agricultural production activities. They held direct ownership interests in one LLP and one LLC and indirect interests in several other LLPs and LLCs. Their ownership interests were denoted as "limited partners" in the LLP and "limited liability company members" in the LLC – which did have a designated manager. The interests that they held in the two tenancies-in-common were also treated similarly. For tax years 2000-2002, the taxpayers ran up large losses and treated them as ordinary losses. The IRS asserted their position that an LLC member is *always* treated as a limited partner because of their limited liability under state law and because the Code specifies that a limited partnership interest never counts as an interest with respect to which the taxpayer materially participates.<sup>13</sup> So, the IRS characterized the losses as passive and asserted a total deficiency for the years at issue of over \$360,000 and tacked on over \$72,000 in penalties. The IRS based their position on a regulation which, for purposes of I.R.C. §469, treats a partnership interest as a limited partnership interest if "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."<sup>14</sup> The taxpayers argued that the Code and regulations did not apply to them because none of the entities that they had interests in were limited partnerships and because, in any event, they were general partners rather than limited partners. The taxpayers also pointed out that the Federal District Court for Oregon had previously

ruled that, under the Oregon LLC Act, I.R.C. §469(h)(2) did not apply to LLC members.<sup>15</sup>

**The Tax Court's analysis.** The Tax Court first noted that I.R.C. §469(h)(2) was enacted at a time when LLCs and LLPs were either new or nonexistent business entities<sup>16</sup> and, as such, did not make reference to those entities. The court also pointed out that the regulations did not refer explicitly to LLPs or LLCs. Accordingly, the court rejected the IRS argument that a limitation on liability *automatically* qualifies an interest as a limited partnership interest under I.R.C. §469(h)(2).<sup>17</sup> On the contrary, the court held that the correct analysis involves a determination of whether an interest in a limited partnership (or LLC) is, based on the particular facts, actually a limited partnership interest.<sup>18</sup> That makes a state's LLC statute particularly important. Under the Iowa LLC Act,<sup>19</sup> LLC and LLP members are granted power and authority beyond those that limited partners have traditionally been allowed.<sup>20</sup> Other distinguishing features were also present. The court noted that limited partnerships have two classes of partners, one of which runs the business (general partners) and the other one which typically involves passive investors (limited partners). The limited partners enjoy limited liability, but that protection can be lost by participating in the business. By comparison, an LLP is essentially a general partnership in which the general partners have limited liability even if they participate in management.<sup>21</sup> Likewise, the court noted that LLC members can participate in management and retain limited liability.<sup>22</sup>

The Tax Court also noted that the United States Federal District Court for the District of Oregon<sup>23</sup> had reached the same conclusion in 2000 – that the regulation automatically treating a partnership interest as a limited partnership interest if liability of the interest holder is limited under state law<sup>24</sup> was obsolete when applied to LLCs because the LLC statute at issue (the Oregon statute) created a new type of business entity materially distinguishable from a limited partnership.

The court made a key point that it was not invalidating the temporary regulations, but was simply declining to write a regulation for the Treasury that applied to interests in LLCs and LLPs. Importantly, the court refused to give deference to the Treasury's litigating position in absence of such a regulation.

As for the taxpayers' tenancy-in-common interests, the court also held that they were not limited partnership interests as defined by I.R.C. §469(h)(2).

### **The Court of Federal Claims Case<sup>25</sup>**

In this case, the taxpayer held a 99 percent interest in an LLC that was formed under the Texas LLC statute. He held the other one percent interest indirectly through an S corporation. The LLC's articles of organization designated the taxpayer as the manager. The LLC did not make an election to be taxed as a corporation and, thus, defaulted to partnership tax status. The LLC, which provided charter air services, incurred losses in 2002 and 2003 of \$1,225,869 and \$939,878 respectively which flowed through to the taxpayer. The IRS disallowed most of the losses on the basis that the taxpayer did not meet the more rigorous test for material participation that applied to limited partners in limited partnerships. The taxpayer paid the additional tax of \$863,124 and filed a refund claim for the same amount. The IRS denied the refund claim and the taxpayer sued for the refund, plus interest. Both the taxpayer and the IRS moved for summary judgment.

The IRS stood by its position that the more rigorous material participation test applied because the taxpayer enjoyed limited liability by owning the interests in the LLC just like he would if he held limited partnership interests. Thus, according to the IRS, the taxpayer's interest was identical to a limited partnership interest and the regulation applied triggering the passive loss rules. But, the court disagreed with the IRS. While both parties agreed that the statute and regulations trigger application of the passive loss rules to limited partnership interests, the taxpayer pointed out that he didn't hold an interest in a limited partnership. The court noted

that the language of the regulation<sup>26</sup> explicitly required that the taxpayer hold an interest in an entity that is a partnership under state law, and that the Treasury had never developed a regulation to apply to LLCs. It was clear that the taxpayer's entity was organized under Texas law as an LLC. In addition, the court pointed out that the taxpayer was a manager of the LLC, and IRS had even conceded at trial that the taxpayer would be deemed to be a general partner if the LLC were a general partnership. The court noted that the position of the IRS that an LLC taxed as a partnership triggers application of the Treas. Reg. §1.469-5T(e)(3)(ii) was "entirely self-serving and inconsistent." The court also stated that it was irrelevant whether the taxpayer was a manager of the LLC or not – by virtue of the LLC statute, the taxpayer could participate in the business and not lose the feature of limited liability.

**Note:** On March 9, 2010, IRS issued an acquiescence in result only to the court's decision in *Thompson*, referencing the similar outcomes in *Garnett* and *Gregg*.

### **The Tax Court's Summary Opinion<sup>27</sup>**

The Tax Court, in early October of 2009, issued a Summary Opinion<sup>28</sup> that followed its earlier position taken in *Garnett*.<sup>29</sup> In *Hegarty v. Comr.*,<sup>30</sup> the court reiterated its position that the reliance by IRS on I.R.C. § 469(h)(2) to treat members of LLCs as automatically limited partners for passive loss purposes is misplaced. Instead, the general tests for material participation apply and the petitioners in the case (a married couple) were determined to have materially participated in their charter fishing activity for the tax year at issue. They participated more than 100 hours and their participation was not less than the participation of any other individual during the tax year.

### **The Tax Court's Memorandum Opinion<sup>31</sup>**

In early 2010, the Tax Court again dealt with the issue of the passive loss rules in the context of a taxpayer's interest in an LLC.<sup>32</sup> In this case, the taxpayer's primary business activity was managing various real estate

investments. He spent more than one-half of his time and more than 750 hours annually in real property trade or business activities. During the years at issue, the taxpayer was the sole owner of an S corporation that manufactured and installed carpentry items, and his participation in that business qualified as a significant participation activity for purposes of the passive loss rules. He also owned 33 percent of the member interests in a California-law LLC engaged in the business of owning and operating a golf course, restaurant and country club. The LLC was treated taxwise as a partnership. It was undisputed that the taxpayer was the managing member of the LLC. For tax years 2001-2003, IRS claimed that the losses the taxpayer incurred from both the S corporation and the LLC were passive losses that were not currently deductible. While the parties agreed that the taxpayer's participation in both the S corporation and the LLC satisfied the significant participation activity test under the passive loss rules, IRS again asserted its position that I.R.C. §469(h)(2) required that the taxpayer's interest in the LLC be treated as a passive limited partnership interest, even though IRS conceded that the taxpayer held the managing member interest in the LLC.

The Tax Court rejected the IRS' argument, noting again (as it had in *Garnett*) that the general partner exception of Treas. Reg. §1.469-5T(e)(3)(ii) was not confined to the situation where a limited partner also holds a general partnership interest. Under the exception, an individual who is a general partner is not restricted from claiming that the individual materially participated in the partnership. Here, it was compelling that the taxpayer held the managing member interest in the LLC. As such, the taxpayer's losses were properly deducted.

### **Conclusion and Proposed Regulations**

As for *Garnett*,<sup>33</sup> The Tax Court's opinion doesn't settle the matter. In that case, the court granted the taxpayers' motion for summary judgment that I.R.C. §469(h)(2) did not apply to them. IRS can still challenge the taxpayers'

losses under the normal test for material participation. Unlike *Garnett*,<sup>34</sup> the Court of Federal claims in *Thompson*<sup>35</sup> noted that no additional analysis was necessary concerning whether the passive loss rules applied to the taxpayer under the general tests for material participation. It was clear that the taxpayer did not hold a limited partnership interest. The same conclusion was reached in *Newell*.<sup>36</sup>

On a broader scale, however, the issue will continue to boil down to the particular provisions of a state's LLC statute and whether there are sufficient factors under the state statute that distinguish an LLC from a limited partnership.<sup>37</sup> That will be the case until IRS issues regulations dealing specifically with LLCs and similar entities.

In any event, it is curious why the IRS even challenged the taxpayers in this case. If they were to win on their argument that losses by "limited partners" in an LLC or LLP are always passive, then the income from such interests would also be passive.<sup>38</sup> That would certainly lead to the sheltering of this "passive" income in some other form of tax shelter.<sup>39</sup>

On November 28, 2011, the Treasury Department proposed regulations defining "limited partner" for purposes of the passive loss rules.<sup>40</sup> The proposed definition would make it easier for LLC members and some limited partners to satisfy the material participation requirements for passive loss purposes, consistent with the court opinions that IRS has recently lost on the issue. Specifically, the proposed regulations require that two conditions have to be satisfied for an individual to be classified as a limited partner under I.R.C. §469(h)(2): (1) the entity must be classified as a partnership for federal income tax purposes; and (2) the holder of the interest must not have management rights at any time during the entity's tax year under local law and the entity's governing agreement. Thus, LLC members of member-managed LLCs would be able to use all seven of the material participation tests, as would limited partners that have at least some rights to participate in managerial control or management of a partnership.

The preamble to the proposed regulations specifies that the proposed redefinition of "limited partner" only applies for purposes of the passive loss rules. So, for example, the redefinition would have no application to the self-employment tax treatment of income received by general partners as compared to limited partners.

The proposed regulations are effective for tax years beginning on or after final regulations are published in the Federal Register. Until that time, the IRS and taxpayers can apply either the current rules or the proposed rules to any particular situation.

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<sup>1</sup> I.R.C. §469.

<sup>2</sup> Nondeductible passive losses and credits carry forward indefinitely (to be used against passive activity income in the carry-forward years) until the activity involved is sold. *I.R.C. §469(b)*. Thus, while passive losses that have been carried forward can be claimed in those carry-forward years to offset gain from the sale, for example, of agricultural real estate, investors typically do not like the carry-forward rule because they do not like not being able to claim their losses. Consequently, the rule encourages investors to sell their investments if they cannot deduct the losses.

<sup>3</sup> I.R.C. §469.

<sup>4</sup> The definition of "material participation" is contained in I.R.C. §469(h). However, if a taxpayer fails to meet the material participation test there is a fall-back test of active participation. The active participation test allows a taxpayer to deduct up to \$25,000 each year if the losses are from rental real estate activity. I.R.C. §469(i). Unfortunately, a major problem in the agricultural community is that the IRS has taken the position that a crop-share lease is a joint venture and not a rental real estate activity. *Treas. Reg. §1.469-1T(e)(3)(viii)*, Example 8. Thus, since crop-shares are not "rent," the landlord will not qualify under the active participation test. That means that crop-share leases or custom farming operations (or similar arrangements) must be changed to a cash rent lease to qualify for the \$25,000 deduction. An adjusted gross income limitation also applies, and the active participation test is

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unavailable to corporations and to individuals having less than 10 percent interest in the activity in question. Also, a “real estate professional” (defined as a taxpayer that spends at least 750 hours annually in real property trades or businesses) can use the standard material participation tests. I.R.C. §469(c)(7).

<sup>5</sup> I.R.C. §469(c)(1).

<sup>6</sup> I.R.C. §469(h)(1).

<sup>7</sup> Temp. Treas. Reg. §1.469-5T(a)(1)-(7).

<sup>8</sup> I.R.C. §469(h)(2).

<sup>9</sup> Temp. Treas. Reg. §1.469-5T(a)(1).

<sup>10</sup> Temp. Treas. Reg. §1.469-5(T)(a)(5).

<sup>11</sup> Temp. Treas. Reg. §1.469-5(T)(a)(6).

<sup>12</sup> Garnett v. Com’r, 132 T.C. No. 19 (2009).

<sup>13</sup> I.R.C. §469(h)(2).

<sup>14</sup> Temp. Treas. Reg. §1.469-5T(e)(3)(i)(B).

<sup>15</sup> Gregg v. United States, 186 F. Supp. 2d 1123 (D. Ore. 2000).

<sup>16</sup> The court noted that, while I.R.C. §469(h)(2) was enacted in 1986, LLPs did not come into existence until 1991 and only Wyoming had an LLC statute as of 1986.

<sup>17</sup> The court also noted that the taxpayers’ interest had to be a limited partnership interest as a limited partner, and that whether the petitioners had limited liability is not the sole consideration.

<sup>18</sup> The court stated that the factual inquiry is to be made under the general tests for material participation – the seven-factor analysis. The court also rejected the taxpayers’ proposed definition of a limited partner on the grounds that a strict and literal meaning would be counter to Congressional intent to treat substantially equivalent business entities and interests in those entities as limited partnerships and interests held by limited partners.

<sup>19</sup> See Iowa Code §490A.

<sup>20</sup> IRS conceded this point.

<sup>21</sup> See Iowa Code §§486A.101; 486A.1001.

<sup>22</sup> See Iowa Code §490A.

<sup>23</sup> Gregg v. United States, 186 F. Supp. 2d 1123 (D. Ore. 2000).

<sup>24</sup> Temp. Treas. Reg. §1.469-5T(e)(3)(i)(B).

<sup>25</sup> Thompson v. United States, 87 Fed. Cl. 728 (2009).

<sup>26</sup> Treas. Reg. §1.469-5T(e)(3).

<sup>27</sup> T.C. Sum. Op. 2009-153.

<sup>28</sup> Tax Court Summary Opinions cannot be cited as precedent.

<sup>29</sup> 132 T.C. No. 19 (2009).

<sup>30</sup> T.C. Sum. Op. 2009-153.

<sup>31</sup> Newell v. Comr., T.C. Memo. 2010-23.

<sup>32</sup> Id.

<sup>33</sup> 132 T.C. No. 19 (2009).

<sup>34</sup> Id.

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<sup>35</sup> Thompson v. United States, 87 Fed. Cl. 728 (2009). IRS has acquiesced in result only to the court’s decision in *Thompson*. A.O.D. 2010-14 (Apr. 5, 2010).

<sup>36</sup> Newell v. Comr., T.C. Memo. 2010-23.

<sup>37</sup> There are three primary factors that distinguish an LLC from a limited partnership: (1) an LLC does not have at least one general partner and one limited partner if all members are treated as limited partners; (2) the LLC members retain their limited liability regardless of their level of participation in the entity’s management; and (3) an LLC permits active involvement in the management of the business while affording the members limited liability.

<sup>38</sup> Under existing regulations, IRS does have the power to recharacterize passive income as non-passive which would then be ineligible to offset passive losses.

<sup>39</sup> Joe Kristan, in his online blog (<http://www.rothcpa.com/taxupdates.php>), has also questioned why the government has raised the passive loss arguments with respect to interests in LLCs.

<sup>40</sup> Notice of Proposed Rulemaking REG-109369-10 (Nov. 28, 2011).