# DOES PROPOSED REGULATION REG -109369-10, FED. REG. 228, 72875 (NOVEMBER 28, 2011) RESOLVE THE PROBLEM OF MATERIAL PARTICIPATION AND PASSIVE LOSS TREATMENT FOR LIMITED LIABILITY COMPANIES?

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A new business faces a choice of entity decision at its inception. The choice made has profound implications on the business and its owners. The objective is to determine the best entity type for that business. The entity choice must be the most advantageous entity type for business operations and taxation of the business and its owners. With operations and taxation in mind, a popular entity option today is the Limited Liability Company (LLC). The current regulations treat interest in Limited Liability Companies as limited partnership interests, presume non-material participation, and limit the use of passive losses. Case law and Proposed Regulation REG -109369-10, Fed. Reg. 228, 72875 (November 28, 2011) significantly affect the issue of material participation and passive loss treatment on members of Limited Liability Companies. This paper will examine the current rules, case law history and the potential effect of Proposed Regulation REG -109369-10, Fed. Reg. 228, 72875 (November 28, 2011) on members of Limited Liability Companies.

The LLC option achieves the nontax objectives of a small business in that it provides the members with limited liability and a great deal of operating flexibility unavailable with other business entity options. A limited liability company is a business entity created under state law. It is a hybrid having the characteristics of both a corporation and partnership. The LLC has great flexibility in the way it operates and does not follow corporate formalities. The flexibility also extends in the area of taxation. Under the check the box rules, an LLC can choose to be taxed as a partnership, a C corporation, or an S corporation for federal tax purposes. The most tax advantageous choice for the LLC would be Partnership. Limited Liability Companies would therefore be tax conduits, or pass-through entities.

Temporary Regulation Section 1.469-5T was adopted in 1988. Section 1.469-5T was put in effect before Limited Liability Companies were an entity option. Therefore, at the time the Regulations went into effect, Congress and Treasury only contemplated partnerships interests to be either limited or general. In applying the material participation test for passive loss purposes the temporary regulations treat interest like those in a limited liability company as limited partnership interests because the holder has limited liability under the law of the state where it was organized. In applying the temporary Regulations to members of an LLC, member interests

are considered limited partner interests. Limited partners are generally presumed not to materially participate in the management of the business and therefore the passive loss limits apply.

A Limited Liability Company choosing to be taxed as a partnership will file Form 1065, which is an information return and will provide the individual partners with a separate schedule K-1. Form 1065 is divided into two general categories. The first category is for income and deductions related to the partnership ordinary trade or business income. The second category is for other items that are required to be separately stated. These separately stated items include passive and investment income, special deductions, and credits. The individual-owner partners would then report the information on Form K-1 on their personal income tax return Form 1040, Schedule E, page 2. Any resulting losses, including passive losses, flow through to the owner-partners and any limits would be applied at the owner level.

Most losses come within the scope of section IRC 165. Losses incurred in connection with a trade or business are generally deductible. The tax code specifically imposes restrictions on deductibility of investor or passive losses. In the past, the unrestricted ability to use investment or passive losses to offset income could enable a taxpayer to avoid taxation. Many times transactions and businesses were entered into solely for the losses that would be generated. This type of transaction is called a tax shelter. There were many abuses in this area and legislation such as IRC Section 469 was enacted to address these tax shelter abuses. Losses in many cases are now subject to limitations. The at-risk loss limits in IRC section 465 and passive loss limits in IRC section 469 must be carefully applied to partnership losses and their effect on the individual investor-taxpayer partners.

Before applying the loss rules, income and losses must be separated into three categories, active, portfolio, and passive. Active income is the income from wages, salary, and other payments for services rendered, the profit from trade or business activity in which taxpayer materially participates, the gain from sale or disposition of assets used in an active trade or business, and income from intangible property created by taxpayer. Portfolio income is interest, dividends, annuities, certain royalties not derived in the ordinary course of business, and the gains from sale of assets that produce portfolio income or that are held for investment. Passive income and loses are from trade or business activities in which a taxpayer does not materially participate, and certain rental activities. The deduction of passive losses against active or portfolio income is disallowed. Passive losses can only offset passive income. Disallowed losses are suspended and carried forward. Suspended losses are ultimately deductible in the year the related activity is disposed of in a fully taxable transaction. The issue of the passive loss limitation depends essentially on material participation.

Material participation means that a taxpayer is involved in the operation of the activity on a regular, continuous, and substantial basis. An evaluation of the time devoted to and nature of the activity performed for the business must done to determine whether taxpayers materially participate. An activity is treated as active rather than passive and thus, not subject to the passive loss limits if a taxpayer meets one of seven material participation tests found in Temporary Regulation Section 1.469-5T. Therefore, we must carefully examine what constitutes material participation. We must look at the Code, current Regulations, case law, and proposed Regulations to determine the current and possible future meaning of material participation, especially as it pertains to LLC member interests.

The seven Material Participation Tests are:

Test 1

- Taxpayer participates in the activity more than 500 hours during the year.

- Test 2
  - Taxpayer's participation in the activity is substantially all of the participation in the activity of all individuals for the year.
- Test 3
  - Taxpayer participates in the activity more than 100 hours during the year and not less than the participation of any other individual in the activity.
- Test 4
  - Taxpayer's participation in the activity is significant and taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours
  - Significant participation is more than 100 hours.
- Test 5
  - Taxpayer materially participated in the activity for any 5 years during the last 10 year period.
- Test 6

  The activity is a personal service activity in which the taxpayer materially participated for any three preceding years. Personal service activity is defined as the performance of personal service in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting or to and any other trade or business in which capital is not material income producing factor.
- Test 7
  - Based on the facts and circumstances, taxpayer participated in the activity on a regular, continuous, and substantial basis. Regular, continuous, and substantial are not defined in the Regulations. Participation generally includes any work done by an individual in an activity that he or she owns. Participation does not include work if of a type not customarily done by owners and if one of its principal purposes is to avoid the disallowance of passive losses or credits. Work done in an individual's capacity, as an investor is not counted in applying the material participation tests.

Under the regulations, Section 1.469 – 5T, an individual may establish material participation in the activity under one of seven tests listed above. If the interest held is as a limited partnership more restrictive limitations apply. The limited partners have only three of the seven tests available to establish material participation. For LLC members treated as having a limited partnership interest tests 1, 5, or 6 must be satisfied to avoid passive loss treatment.

Over the past decade, the federal courts have heard several cases dealing with the treatment of LLC interests as limited partnership interests in applying Temporary Regulations 1.469-5T. The Tax Court, Federal Claims Court, and District Court have consistently held in favor of LLC member taxpayers. The courts, in essence, have held that LLC member interests are not the same as limited partnership interests. The cases hold that the higher material participation requirement imposed on limited partners should not apply to LLC members. Therefore, an LLC member could satisfy any of the seven tests listed in the temporary regulations to show material participation.

Case Law History:
S.A. Gregg v. United States 186 F. Supp. 2d 1123 District Ct Oregon 2000,
The issue of first impression in this case was whether a member of an LLC should be treated as a limited partner or general partner for Section 469 purposes. The District Court ruled in favor of

the taxpayer. The higher material participation requirement imposed on limited partnership interests should not apply to LLC members. An LLC member could satisfy any of the seven tests listed in the temporary Regulations.

P.D. Garnett v. Commissioner 132 T.C. 368 Tax Court 2009,
The IRS suffered its second defeat in this Tax Court case on the same issue. The temporary Regulations attempt to pigeonhole the ownership interest as either general partnership interests or limited partnership interests. The Tax Court ruled that LLC interests fall under the general partner exception found in the Regulations.

J.R. Thompson v. United States 87 Fed Claims Court 728 2009,
Again the dilemma of how to treat the LLC interest presented itself and again the IRS suffered a loss. The Federal Claims court this time states that the temporary Regulations are ambiguous as to the treatment of LLC member interests. In this case, the federal court of claims decided the ambiguity in the regulations should be interpreted in favor of the taxpayer.

S.K. Hegarty T.C. Summary Opinion 2009-153 October 6, 2009
Citing P.D. Garnett v. Commissioner 132 T.C. 368 Tax Court 2009, the tax court ruled that LLC members could satisfy material participation by using any one of the seven tests.

L.E. Newell v. Commissioner T.C. Memo 2010-23,
The IRS again loses in favor of a LLC member taxpayer. The Tax Court rules Section 469(h)(2) did not apply because of the general partner exception.

Action on Decision 2919092, 2010-14 I.R.B. 515,
In its AOD the IRS has acquiesce in result only. The effect of the acquiescence is that the IRS has accepted the holding of the court in J.R. Thompson v. United States 87 Fed Claims Court 728 2009 and will follow it only in cases with the exact same facts, but disagrees with the reasoning of the court in reaching its decision. This provides no real assurance of the IRS position regarding other LLC member taxpayers with similar, but not exact facts as in J.R. Thompson v. United States 87 Fed Claims Court 728 2009.

Although the trend in these court cases leans toward an easier material participation standard for LLC members, there is no guarantee that the IRS will follow this trend. The IRS, the courts, and taxpayers agree that clarity is needed in this area.

With proposed regulation REG -109369-10, Fed. Reg. 228, 72875 (November 28, 2011), the IRS acknowledges that the Temporary Regulations pose problems with regard to LLC interests. With this proposed regulation, the IRS also acknowledges the tendency of the courts to favor taxpayers in disputes regarding the treatment of theses LLC interest as it relates to Section 469. The proposed changes to the regulations are as a result of several attempts by the IRS to characterize membership interests in a limited liability company as limited partnership interests. The main purpose of the proposed regulations is to redefine what a limited partnership interest is and the effect on LLC's.

The proposed regulation now recognizes the existence of limited liability companies and the relaxation of state law on the right of a limited partner to participate in management without losing limited liability. New York State is one of those states with those relaxed rules. New York has adopted RULPA, the Revised Uniform Limited Partnership Act, which allows limited partners to participate in management and control of a partnership without losing limited liability protection. Under the proposed Regulations a limited partnership interests will be defined as an

interest in an entity treated as a partnership for federal tax purposes, and the interest holder will not have rights to manage the entity at all times during the entity's tax year. What does "right to manage" mean? In its attempt to clear up any ambiguity regarding treatment of LLC interests as limited partnership interest the Treasury uses the undefined term "right to manage" and creates another ambiguity. The preamble to the proposed Regulation states the "right to manage" is the power to bind the entity. No further explanation of what "right to manage" for the purpose of applying the regulation to LLCs is given. The proposed regulation uses the "right to manage" as the key words for the definition of what a limited partnership interest is. There is no guidance or definition regarding the meaning of the term. Material participation now centers on the partner's right to participate in management of the entity. The fact that the "right to manage" can be interpreted in different ways creates a high degree of uncertainty.

An LLC is not a limited partnership, but rather a hybrid possessing characteristics of limited partnership and general partnership. LLC members in RULPA states like New York have an inherent "right to manage". N.Y. LLC Law Section 102(r)(iii) states that a membership interest in a NY Limited Liability Company, grants a member a right, without limitation to vote and participate in the management of the limited liability company. If LLC members under state law have a right to manage then what does that mean with regard to passive loss treatment? The proposed regulation does not explain or give examples. Until the proposed regulation has been finalized, the current operative law is the temporary regulation and case law modifying the LLC member treatment. Any advice given must be made with regard to the current law in effect and a mind toward the proposed changes coming. Taxpayers affected by this issue must request and receive a positive response to a private letter ruling on this matter. Taxpayers affected by this issue must have a clear understanding of how the code, regulations, and case law will be applied by the IRS in their specific situation, before proposed regulation REG -109369-10, Fed. Reg. 228, 72875 (November 28, 2011) becomes final and effective.

**REFERENCES**

IRC section 165,
IRC section 465,
IRC section 469,
Treasury Reg. Section 1.469-5T,
*Gregg v. United States 186 F. Supp. 2d 1123 District Ct Oregon 2000,*
*Garnett v. Commissioner 132 T.C. 368 Tax Court 2009,*
*Thompson v. United States 87 Fed Claims Court 728 2009,*
*S.K. Hegarty T.C. Summary Opinion 2009-153 October 6, 2009,*
*Newell v. Commissioner T.C. Memo 2010-23*,
Action on Decision 2919092, 2010-14 I.R.B. 515,
Proposed regulation REG -109369-10, Fed. Reg. 228, 72875 (November 28, 2011).
New York Revised Uniform Limited Partnership Act
New York Limited Liability Company Law