



Michael J. Grace
 Managing Director
 mgrace@milbank.com
 (202) 835-7532

Milbank Tax Lawyer Comments on Proposed Regulations Redefining “Limited Partner”

Michael J. Grace, JD, Managing Director-TAARS®, on December 1, 2011 commented in a major tax publication on recently proposed regulations defining “limited partner.” This updated definition would make it easier for members of limited liability companies (“LLCs”) and some limited partners to “materially participate” under the passive activity limitations (described below). The proposed regulations would update regulations issued in 1988 of which MJG when at the IRS served as Principal Author. Michael’s recent comments supplement an analysis of the same subject he had published while the U.S. Treasury Department/IRS were developing the updated regulations. See [“Milbank Tax Attorney Suggests Updating Regulations on Material Participation by LLC Members.”](#)

Pertinent Rules

Tax Limitation Generally. Intended to curtail abusive tax shelters, Section 469 of the Internal Revenue Code, “Passive Activity Losses and Credits Limited,” disallows passive activity losses and passive activity credits of individuals, estates, trusts, closely held C corporations, and personal service corporations. Those taxpayers generally may not deduct net losses (deductions exceeding gross income) from passive activities. Disallowed net losses carry forward indefinitely until the taxpayer can use them subject to these limitations.

Passive Activities. In general, “passive activities” fall into two categories: (i) any rental activity, and (ii) any trade or business activity in which a taxpayer does not “materially participate.”

Material Participation. Under IRC Section 469(h)(1), a taxpayer in order to satisfy the material participation requirement must participate in an activity regularly, continuously, and substantially. Regulations prescribe seven alternative “tests” under which a taxpayer may satisfy this standard. In general, a taxpayer may materially participate in an activity by satisfying any one of the seven tests. See Treas. Reg. Section 1.469-5T(a).

By statute (IRC Section 469(h)(2)), a limited partner may not materially participate in an activity except as regulations otherwise provide. Current Treas. Reg. Section 1.469-5T(e) (2) (1988) allows limited partners to use only three of the seven regulatory tests for material participation. Under the most frequently used test, a limited partner may materially participate in an activity by participating in it more than 500 hours during a tax year. The other two tests available to a limited partner deem the material-participation standard currently satisfied if the individual materially participated for a prescribed number of previous years.

Limited Partnership Interests

Under current Treas. Reg. Section 1.469-5T(e)(3)(i), a partnership interest is a limited partnership interest for purposes of these material-participation rules in either of two situations:

1. The interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the interest holder's liability for obligations of the partnership is limited under the applicable State law; or
2. The liability of the holder for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

In the second situation, a member of a LLC generally is a limited partner for material-participation purposes. That's because a LLC member's liability generally is limited to the amount the member contributes to the LLC.

Under the "General Partner Exception" in Treas. Reg. Section 1.469-5T(e)(3)(ii), a limited partner is not treated as such if the interest holder is also a general partner in the same partnership. A partner qualifying under this exception may access all seven generally applicable tests for material participation.

Judicial Criticism of Current Definition

Since 2000, a number of courts have criticized the way the current regulations define "limited partner." These courts using various rationale have held that members of particular LLCs were not limited partners. As a result, these particular LLC members could rely on all seven regulatory tests to establish that they materially participated. See Newell v. Commissioner, TC Memo 2010-23; Hegarty v. Commissioner, TC Summary Opinion 2009-153; Thompson v. United States, 87 Fed. Cl. 728, 104 AFTR 2d 2009-5381 (Fed. Cl. 2009); Garnett v. Commissioner, 132 T.C. No. 19 (2009); Gregg v. United States, 186 F. Supp. 2d 1123, 87 AFTR 2d 2001-337, 2001-1 USTC Par. 50,169 (D. Ore. 2000).

This string of losses in court prompted the U.S. Treasury Department and IRS to revisit the definition of "limited partner" under IRC Section 469(h)(2). Notice of Proposed Rulemaking REG-109369-10, published in the Federal Register November 28, 2011, proposes regulations defining an "interest in a limited partnership as a limited partner."

Proposed New Definition

The proposed regulations prescribe two conditions both of which must be met for an individual to be treated as a limited partner under IRC Section 469(h)(2). The proposed regulations also retain but clarify the General Partner Exception.

Dual Conditions. The proposed dual conditions for a limited partner are:

1. The entity is classified as a partnership for Federal income tax purposes under Reg. Section 301.7701-3; and
2. The holder of the 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.

Under Reg. Section 301.7701-3 (which the first preceding condition cross references), a "business entity" having at least two members generally is classified as a partnership for Federal income tax purposes.

Ramifications. If the proposed regulations are adopted, then two categories of individuals whom the current regulations generally categorize as limited partners no longer will be treated as such. Consequently, these individuals will be able to use all seven material-participation tests: (i) LLC members of member-managed LLCs, and (ii) limited partners having some rights to participate in control or management of a partnership. Compared to results under current rules, these individuals less likely will have passive losses limited by Section 469 from LLCs or limited partnerships (as the case may be).

Rationale for Changes. The proposed regulations embrace ways in which state laws have evolved since the current regulations were issued. Under the Uniform Limited Liability Company Act, a LLC member may participate in management to any extent without losing limited liability. Traditionally, a limited partner as such could not get involved in managing a partnership's affairs. By participating in management, the partner would lose the intended limitation on liability. See, for example, the Uniform Limited Partnership Act of 1916. More recently, the Revised Uniform Limited Partnership Act of 1985 and derivations thereof permit a limited partner to participate in management without losing limited liability.

Prediction. The updated definition of "limited partner" likely will not usher in a new era of widely promoted partnership (or LLC) tax shelters. Typically, a passive investor in a partnership will not have rights to manage or control the partnership's activities (see Dual Condition 2, above). Additionally, it's difficult for a passive investor to satisfy any of the seven tests for material participation. But, as previously explained, LLC members and limited partners who do participate in an entity's activities now will have expanded opportunities to prove they materially participate and thus to avoid passive losses.

Other Applications. In the preamble to the proposed regulations, the Government states that the proposed redefinition of limited partner applies solely for purposes of Section 469; "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." For example, general partners compared to limited partners are taxed differently on self-employment income under IRC Sections 1401-1403. The preamble's warning against other inferences means, for example, that the proposed regulations under IRC Section 469 do not apply for self-employment tax purposes.

Effective Date. The proposed regulations technically will apply only to taxable years beginning on or after conforming final regulations are published in the Federal Register. However, the proposed rules as previously explained react to judicial decisions criticizing the current regulations. No one definitively can predict any position the IRS may take in examining particular tax returns or litigating particular cases. It seems worth conjecturing, however, that the IRS, having lost court cases interpreting the current regulations, may follow the proposed rules even before they officially take effect. Similarly, taxpayers might argue (in appropriate situations) that the proposed regulations represent the IRS's position even though they officially have not yet taken effect. Note, however, that until the anticipated new regulations officially have been adopted, both the IRS and particular taxpayers may attempt to apply either the current rules or the proposed rules, depending on which rules suggest the preferred outcome.

Grace's Observations

Federal Tax Weekly for December 1, 2011, published by CCH, a Wolters Kluwer business, quoted Michael Grace as follows:

"The proposed regulations like the original rules draw "bright lines" but embrace evolutions since 1988 in state laws and entity choices (including LLCs) for tax purposes.... Helpfully, the updated rules rely on classifications under federal income tax law as one indicator of a limited partnership interest; the original regulations drew upon elements of both federal tax law and state non-tax law,.... The new rules intelligently focus on the holder's "rights" to manage an entity rather than on whether and how much the holder actually manages the entity's affairs. Some relevant judicial decisions have suggested distinguishing limited partners from general partners based on the extent to which an interest holder actually manages, an approach inviting disagreements between taxpayers and revenue agents."

About Milbank Tax

Milbank has one of the most dynamic tax practices of any major law firm. Our tax lawyers work in specialized, but overlapping, practice teams organized to ensure highly developed legal expertise, intensive contact with the business environment in each practice area and unparalleled efficient delivery of highly valued advice. The depth and organization of our tax group supports the creative interaction with our clients that has become the hallmark of our practice. For details about Milbank's tax practice, please visit www.milbank.com.

www.milbank.com

Attorney advertising. Prior results do not guarantee a similar outcome.