Keeping Pace with the Times: Exploring the Meaning of *Limited Partner* for Purposes of the Internal Revenue Code

Kristin Balding Gutting[*]

> *I am certainly not an advocate for frequent and untried changes in laws and constitutions. I think moderate imperfections had better be borne with; because, when once known, we accommodate ourselves to them, and find practical means of correcting their ill effects. But I know also, that laws and institutions must go hand in hand with the progress of the human mind. As that becomes more developed, more enlightened, as new discoveries are made, new truths disclosed, and manners and opinions change with the change of circumstances, institutions must advance also, and keep pace with the times. We might as well require a man to wear still the coat which fitted him when a boy, as civilized society to remain ever under the regimen of their barbarous ancestors.*[1]

I. INTRODUCTION

The term "limited partner" appears dozens of times throughout numerous sections of the Internal Revenue Code (the Code).[2] The Treasury Regulations also refer to the term at least eighty-five times.[3]

---

[*] Assistant Professor of Law, Charleston School of Law. LL.M. in Taxation, University of Florida, Fredric G. Levin College of Law; J.D., St. Louis University School of Law; B.S. in Accounting, Valparaiso University. I express my deepest gratitude to J. Abraham Gutting for his review of earlier drafts. I thank the participants at the Southeastern Law Scholars Conference for helpful comments on and ideas for this Article. I also thank my research assistants Beth Santilli, M. Todd Lewis, and J. Aaron Nelson, Jr. for their tireless efforts and my colleague William Gaskill for additional research support. Finally, I thank Jeffrey Toberer, Don Dworak, and Megan Snow at Stinson Morrison Hecker LLP in Omaha, Nebraska (*Garnett* case attorneys) and Tom Helfant and Dana Lipp at Winstead, Sechcrest & Minick, PC in Dallas, Texas (*Thompson* case attorneys) for graciously providing me with the brief and transcripts from their respective cases.

1. Letter from Thomas Jefferson to Samuel Kercheval (July 12, 1816), *in* 12 THE WORKS OF THOMAS JEFFERSON 3, 11–12 (Paul Leicester Ford ed., 1905).

2. *See, e.g.*, I.R.C. §§ 464, 469, 772, 1256, 1258, 1402, 9701 (2006).

3. *See, e.g.*, Treas. Reg. §§ 1.42-2, 1.42-13, 1.280G-1, 1.414(c)-3, 1.469-0, 1.469-2, 1.469-4, 1.469-9, 1.514(c)-1, 1.701-2, 1.704-1, 1.704-2, 1.752-2, 1.874-1, 1.882-4, 1.904-5, 1.922-1, 1.1001-2, 1.1362-2, 1.6015-5, 25.2704-1, 54.4980G-3, 301.6011-3, 301.6231(a)(7)-1 (2011). *See also* Temp. Treas. Reg. §§ 1.165-13T, 1.367(a)-1T, 1.448-1T, 1.469-1T, 1.469-2T, 1.469-4T, 1.469-5T, 1.861-9T, 1.892-5T, 301.6111-1T (2011).

Accordingly, the tax treatment in several provisions of the Code turns on whether a person is a limited partner. The incorporation of a majority of these references into the Code, however, occurred in a simpler time and when the United States did not have so many entities to choose from in forming a business—a time when the only well-known types of business entities taxed as partnerships were general partnerships and limited partnerships. Since the early 1990s, the United States has seen the creation of many new types of limited liability entities, including the Limited Liability Company (LLC),[4] the Limited Liability Partnership (LLP),[5] and the Limited Liability Limited Partnership (LLLP)[6]—all of which are generally treated as partnerships for tax purposes.[7] Thus, how does the term "limited partner," which Congress placed in the Code before these new entities existed, apply to limited liability entities? Furthermore, how will the term apply to a future generation of entities not yet created?[8]

Recently, issues related to application of the phrase "limited partner" in the passive-activity-loss rules of § 469 of the Code drew national attention.[9] Under the special rule of § 469(h)(2) of the Code, which

---

4. *See* discussion *infra* Part III.B. This Article refers only to LLCs with two or more members because single member LLCs are disregarded for tax purposes. Treas. Reg. §§ 301.7701-2(a), 301.7701-3(a).

5. *See* discussion *infra* Part III.C.

6. *See* discussion *infra* Part III.D.

7. Consequently, limited liability entities do not pay income taxes; instead, such entities file annual informational returns. *See* I.R.C. § 701 (stating that partnerships are not subject to an income tax). *See also* INTERNAL REVENUE SERV., FORM 1065, U.S. RETURN OF PARTNERSHIP INCOME (2010), *available at* http://www.irs.gov/pub/irs-pdf/f1065.pdf (providing an example of an informational return form). Limited liability entities provide each partner with an informational return showing the partner's share of the limited liability entity's income, gain, loss, deductions, and credits. INTERNAL REVENUE SERV., SCHEDULE K-1 (FORM 1065), PARTNER'S SHARE OF INCOME DEDUCTIONS, CREDITS, ETC. (2010), *available at* http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf (providing an example of a form used to report a partner's share of his income, deductions, and credits). Ultimately, the partner is liable for tax on his share of the limited liability entity's income, gain, loss, deductions, and credits. I.R.C. §§ 701–702. *But see* Garnett v. Comm'r, 132 T.C. 368, 376 (2009); Treas. Reg. § 301.7701-3(b)(1)(i) (allowing an LLC to elect to "check-the-box" and be taxed as a corporation).

8. While outside the scope of this Article, several states recently have introduced a new form of an LLC, known as a Series LLC. *See* Michael W. McLoughlin & Bruce P. Ely, *IRS Issues Long-Awaited Guidance on Series LLCs; Will the States Soon Follow?*, 20 J. MULTISTATE TAX'N & INCENTIVES 8 (2011) ("To date, eight states have enacted series LLCs statutes . . . ."). *See also* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 2.11 (Supp. 2011) (discussing the classification of a series LLC).

9. *See* Laura Saunders, *Entrepreneurs Win Tax Case Versus IRS*, WALL ST. J., July 8, 2009, at C1 ("The IRS lost a key battle in its long-running fight to limit tax deductions that can be taken by investors in small businesses in a case that could have wide implications for entrepreneurs."). *See also* Sheldon I. Banoff & Richard M. Lipton, *Passive Losses, LLCs and LLPs—Two Courts Reject*

regulates deductions for certain types of losses, more stringent rules apply to limited partners in a limited partnership. For almost twenty years, the Internal Revenue Service (IRS), in audits, has asserted that an interest in an LLC or an LLP should receive the same treatment as a limited partner interest in a limited partnership when applying § 469 of the Code.[10] The IRS's position has resulted in the identification of millions of dollars in deficient federal income taxes.[11]

In *Garnett v. Commissioner*, the United States Tax Court held that a member in an LLC and a limited partner in an LLP were not limited

the Service's Attempt to Limit Losses, 111 J. TAX'N 204, 204 (2009) ("The definition of a 'limited partner' for purposes of various operative provisions of the Code has long been a mystery, and its meaning for purposes of the passive loss rules is no exception."); Susan Kalinka, Garnett *and* Thompson: *Tax Court Holds LLC and LLP Members Are General Partners Under Code Sec. 469(h)(2); U.S. Court of Federal Claims Agrees, Part I—The Opinions and Their Value to Taxpayers*, TAXES, Sept. 2009, at 7, 7 [hereinafter Kalinka, *Part I: The Opinions and Their Value*] ("One of the most vexing tax issues . . . is whether a member of an LLC or an LLP is a . . . limited partner . . . ."); Susan Kalinka, Garnett *and* Thompson: *Tax Court Holds LLC and LLP Members Are General Partners Under Code Sec. 469(h)(2); U.S. Court of Federal Claims Agrees, Part II: Unanswered Questions*, TAXES, Nov. 2009, at 9, 12 [hereinafter Kalinka, *Part II: Unanswered Questions*] ("[T]here are many . . . unresolved questions concerning the status of an LLP or LLC member as a general or limited partner . . . ."); Martin J. McMahon, Jr., Ira B. Shepard, & Daniel L. Simmons, *Recent Developments in Federal Income Taxation: The Year 2009*, 10 FLA. TAX REV. 79, 123–24 (2010) (acknowledging that interests in LLPs and LLCs "are not to be treated as limited partnership interests under § 469(h)(2)"); William R. Siegel, *Treatment of LLCs Under the Passive Loss Rules—Getting it Straight*, 37 REAL EST. TAX'N 3, 3 (2009) ("[T]he IRS [can] not apply Section 469(h)(2) . . . to treat an LLC member as a limited partner."); Michael G. Stevens, *After* Garnett, Thompson, *and* Hegarty*: LLC Members' Losses No Longer Presumed Passive?*, 12 BUS. ENTITIES, no. 2, 2010 at 4, 4 (stating that "the presumption against material participation by limited partners for purposes of the passive activity rules does not apply to LLC/LLP members"); Donald T. Williamson & A. Blair Staley, *The Application of the § 469 Material Participation Standard to Members of Limited Liability Companies*, 51 TAX MGM'T MEMORANDUM 195, 195 (2010) (stating that the "passive activity loss liability rules . . . are a vexing hurdle"); Paul Caron, *Court: LLCs Not Subject to Limited Partnership Passive Loss Disallowance Rule*, TAXPROF BLOG (July 22, 2009), http://taxprof.typepad.com/taxprof_blog/2009/07/page2/; Daniel N. Erasmus, *USA Tax Court: LLCs Not Subject to Limited Partnership Passive Loss Disallowance Rule*, TAX RISK MGM'T BLOG (July 13, 2009, 5:08 AM), http://taxriskmanagement.blogspot.com ("LLC interests are not subject to § 469(h)(2) . . . ."); Joe Kristan, *Tax Court: LLC and LLLP Owner Losses Don't Have to be Passive*, TAX UPDATE BLOG (July 1, 2009), http:www.rothcpacom/archives/004935.php (opining that new entities—LLCs and LLLPs—are not "comparable to limited partnerships").

10. INTERNAL REVENUE SERV., PASSIVE ACTIVITY LOSS AUDIT TECHNIQUE GUIDE 6-10 (2005) ("Since each member of an LLC has limited liability, investors are analogous to limited partners under IRC § 469. For purposes of passive-loss rules, LLC members are treated as limited partners, even if the taxpayer is a member-manager."); *see* Daniel S. Kleinberger, Essay, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 FORDHAM J. CORP. & FIN. L. 445, 453–54 (2009) ("[I]n both official and unofficial ways, the IRS suggested that, for purposes of tax classification, LLCs were properly analogized to limited partnerships rather than to general partnerships.").

11. *See, e.g.*, Newell v. Comm'r, 99 T.C.M. (CCH) 1107, 1107 (2010) (alleging deficiencies of $1,958,442); Thompson v. United States, 87 Fed. Cl. 728, 731 (2009) (alleging deficiencies of $863,124); *Garnett*, 132 T.C. at 368 (alleging deficiencies of $361,468).

partners for purposes of the passive-loss rules.[12] Three weeks later, in *Thompson v. United States*, the United States Court of Federal Claims reaffirmed that for purposes of the passive-loss rules, LLC members are not limited partners.[13] The Court of Federal Claims, however, did not address the application of § 469(h)(2) of the Code to LLPs.[14] Almost a year later, the IRS issued a notice providing that it agreed only with the result in *Thompson*—"that LLC interests are not 'limited-partners interests.'"[15] It is still unclear whether § 469(h)(2) of the Code extends its use of limited partner to a partner in either an LLP or an LLLP. The previous three Department of Treasury's Priority Guidance Plans stated that guidance would be provided in this area.[16] Furthermore, both the United States Tax Court and the United States Court of Federal Claims Court hinted that the IRS could amend the Treasury Regulations to explicitly subject limited liability entities to the per se rule of § 469(h)(2) of the Code.[17] Nonetheless, many commentators believe that the issue is resolved concerning an LLC.[18] This Article proposes that the IRS should

12. *Garnett*, 132 T.C. at 381. *Accord Newell*, 99 T.C.M. (CCH) at 1108; Hegarty v. Comm'r, T.C. Summ. Op. 2009-153 (2009); Gregg v. United States, 186 F. Supp. 2d 1123, 1128 (D. Or. 2000). The government, however, did not appeal *Gregg*, as it was later determined that the taxpayer would win whether or not the taxpayer was determined to be a limited partner. *But see* Defendant's Consolidated Brief on Cross Motions for Partial Summary Judgment Thompson v. United States, 87 Fed. Cl. 728 (2009) (No. 06-211T) [hereinafter Brief for Defendant] ("*Gregg* was wrong to suggest that LLC members should not be treated as holding a limited partnership interest, and, in any event, the decision is not binding on this Court."); INTERNAL REVENUE SERV., *supra* note 10, at 1–7 (noting that *Gregg* was "not a precedent setting case").

13. *Thompson*, 87 Fed. Cl. at 731.

14. *See id.* at 733–34 (discussing application of § 469(h)(2) as it applies to LLCs).

15. *Thompson*, 87 Fed. Cl. 728 (2009), *action on dec.*, 2010-02 (May 21, 2010).

16. DEP'T OF TREASURY, 2011–2012 PRIORITY GUIDANCE PLAN 20 (2011); DEP'T OF TREASURY, 2010–2011 PRIORITY GUIDANCE PLAN 19 (2010); DEP'T OF TREASURY, 2009–2010 PRIORITY GUIDANCE PLAN 25 (2010); CCH, *IRS Acquiesces: LLC Interest Was Not Limited Partnership Interest For PAL Purposes*, STANDARD FED. TAX REPS.: TAXES ON PARADE, March 18, 2010, at 2 (providing that it was the IRS's goal to have new regulations and guidance regarding § 469(h)(2) of the Code and limited partners "by the end of June 2010").

17. *See Thompson*, 87 Fed. Ct. at 738 (citing Gregg v. United States, 186 F. Supp. 2d 1123, 1129 (D.C. Cir. 2000)) (finding that "[i]n the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership" the per se rule of § 469(h)(2) of the Code does not apply to an LLC)); *Garnett*, 132 T.C. at 381 (finding that the effect of the opinion "d[id] not invalidate the temporary regulations . . . but simply decline[d] to fill any gap therein").

18. *See*, *After* Garnett, Thompson, *and* Hegarty*: LLC Members' Losses No Longer Presumed Passive?*, FED. TAXES WEEKLY ALERT ART., Apr. 8, 2010, at 25 (2009) (stating that passive-activity-loss rules do not apply to LLPs or LLCs); *LLC Losses Escape Passive Activity Restriction*, 83 PRAC. TAX STRATEGIES 257, 257 (2009) ("[O]wners of LLC interests [are] not classified as limited partners . . . ."); Gary L. Maydew, *Recent Cases Favorably Apply Passive Activity Loss Rules to LLC Interests*, 83 PRAC. TAX STRATEGIES 260, 260 (2009) ("[There is] reason to believe that LLC members will be treated as general partners for purposes of the passive loss rules."); *Passive Activity*

not amend the regulation; instead, Congress should repeal § 469(h)(2) because in today's business world there is a change of circumstances, and the Code must advance to "keep pace with the times."[19]

Part II of this Article provides an overview of § 469 of the Code, which includes a discussion of the purpose and legislative history behind § 469 of the Code.[20] Part III explores the evolution of limited liability entities and focuses on the participation rights in connection with the limited liability protection of the partners and members of the limited liability entities.[21] Part IV determines that the definition of "limited partner" for purposes of § 469(h)(2) of the Code is based on a partner's or member's ability to participate.[22] In reaching this determination, Part IV explores each of the three governmental branches' views of the term "limited partner" in the context of § 469 of the Code.[23] Part V concludes that § 469(h)(2) of the Code should be repealed in light of today's business environment.[24]

II. SECTION 469 OF THE CODE: THE PASSIVE-ACTIVITY-INVESTMENT-LOSS LIMITATION

A. History and Purpose of § 469 of the Code

In 1986, the marginal rate for an individual taxpayer with income over $88,270 was fifty percent.[25] Accordingly, many taxpayers became involved in tax-driven investments, known as "tax shelters," to reduce their taxable income.[26] Tax shelters, generally, produce losses and deductions—usually exceeding economic reality—to reduce the taxpayer's income from another source.[27] Congress believed that tax

---

Loss Limit Did Not Restrict Managing Member of LLC, 84 PRAC. TAX STRATEGIES 247, 248–49 (2010) (discussing *Garnett* and *Thompson*); *see also* sources cited *supra* note 9.

19. *See* discussion *infra* Part IV.

20. *See infra* Part II.

21. *See infra* Part III.

22. *See infra* Part IV.D.

23. *See infra* Part IV.A–C.

24. *See infra* Part V.

25. S. REP. NO. 99-313, at 713 (1985). The marginal tax rate is the tax rate that a taxpayer would pay on its last taxable dollar.

26. *Id.* at 714.

27. *See* Boris I. Bittker, et al., *A Whirlwind Tour of the Internal Revenue Code's At-Risk and Passive Activity Loss Rules*, 36 REAL PROP. PROB. & TR. J. 673, 677 (2002) (finding that large deductions led to "corresponding large increases in spendable funds"); Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615, 617–27 (1998) (providing an overview of the tax shelters that led to the enactment of the passive-loss rules).

shelters not only lowered revenue, but also undermined compliance by "contribut[ing] to public concerns that the tax system is unfair, and to the belief that tax is paid only by the naïve and the unsophisticated."[28] Congress acted swiftly to stop the tax shelters and "to restore to the tax system the degree of equity that is a necessary precondition to a beneficial and widely desired reduction in rates."[29] Therefore, as part of the Tax Reform Act of 1986[30]—and in response to the increasing number of participants in tax shelters[31]—Congress enacted § 469 of the Code.[32]

Under § 469 of the Code, Congress intended to allow only taxpayers who had "substantial and *bona fide* involvement" in an activity to have the tax preference of using overall losses and deductions created by such activity to offset income from other activities[33] Congress also wanted to continue encouraging passive-investment activities by continuing to permit taxpayers to use overall losses and deductions from a passive activity to offset income from other passive activities.[34] Congress firmly

---

28. S. REP. NO. 99-313, at 714. Congress further observed:

> The committee believes that the most important sources of support for the Federal income tax system are the average citizens who simply report their income . . . and pay tax under the general rules. To the extent that these citizens feel that they are bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself is threatened.

Id.

29. *Id.*

30. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2233 (codified as amended at I.R.C. § 469 (2006)).

31. S. REP. NO. 99-313, at 714. The report further provided:

> The prevalence of tax shelters in recent years—even after the highest marginal rate for individuals was reduced in 1981 from 70 percent to 50 percent—has been well documented. For example, a recent Treasury study revealed that in 1983, out of 260,000 tax returns reporting "total positive income" in excess of $250,000, 11 percent paid taxes equaling 5 percent or less of total positive income, and 21 percent paid taxes equaling 10 percent or less of total positive income. Similarly, in the case of tax returns reporting total positive income in excess of $1 million, 11 percent paid tax equaling less than 5 percent of total positive income, and 19 percent paid tax equaling less than 10 percent of total positive income.

Id. (footnotes omitted).

32. Tax Reform Act of 1986 § 501. Congress observed:

> [R]estricting the use of losses from business activities in which the taxpayer does not materially participate against other sources of positive income (such as salary and portfolio income) addresses a fundamental aspect of the tax shelter problem. . . . Accordingly, . . . the committee believes that it is possible significantly to reduce the tax shelter problem.

S. REP. NO. 99-313, at 716.

33. S. REP. NO. 99-313, at 716.

34. *Id.*

believed, however, that "such [passive] investors should not be permitted to use tax benefits to shelter unrelated income."[35] Accordingly, Congress chose the material-participation standard because "[a] taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive."[36] Additionally, Congress believed that a material-participation standard would cause investors to focus less on the tax benefits of the investment and more on the "nontax economic profit motive."[37]

B. The Mechanics of § 469 of the Code

1. The General Rule

To prevent taxpayers from using losses generated from activities in which the taxpayer passively participated, § 469 of the Code suspends the use of such losses from sheltering other sources of active income, such as compensation.[38] Under § 469 of the Code, an individual, estate, trust, closely held C corporation,[39] or any personal-service corporation[40] may not deduct losses[41] from passive activities that exceed the income

35. *Id.*

36. *Id.* "A taxpayer who materially participates" is more likely to have "sound judgment as to whether the activity has genuine economic significance and value." *Id.*

37. *Id.*

38. STAFF OF THE J. COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 215 (Joint Comm. Print 1987); S. REP. NO. 99-313, at 718–19 ("The bill provides that deductions from passive trade or business activities . . . generally may not be deducted against other income. . . . Under the bill, an activity generally is a passive activity if it involves the conduct of any trade or business, and if the taxpayer does not materially participate in the activity.").

39. I.R.C. §§ 469(j)(1), 465(a)(1)(B), 542(a)(2) (2006) (defining a closely held C corporation as a corporation that is more than 50% owned, directly or indirectly, by five or fewer persons at any time during the last half of the taxable year). The passive-loss rules of § 469 of the Code apply on a limited basis to closely held C corporations. This Article will not discuss these rules in detail, but for a detailed discussion of these rules, see Michael A. Oberst, *The Passive Activity Provision—A Tax Policy Blooper*, 40 U. FLA. L. REV. 641, 648–49, 662–64 (1988).

40. I.R.C. §§ 469(j)(2), 269A(b)(1)–(2) (defining a "personal service corporation" as a corporation in which at least 10% of the stock, by value, is held by employee-owners and whose principal activity is providing personal services that its employees substantially perform). Special rules exist regarding the application of the passive-loss rules of § 469 of the Code to personal service corporations. This Article will not discuss these rules in detail. For a detailed discussion of these rules, see Oberst, *supra* note 39, at 648–49.

41. I.R.C. § 469(a)(1)(B). A similar limitation exists for passive-activity tax credits. *Id.* § 469(a)(1)(B). While a taxpayer may carry over disallowed passive credits to offset future passive income, the disposition of a passive activity does not trigger the use of such credits. *See id.* § 469(b).

from such passive activities.[42] Thus, a taxpayer may not use losses from passive activities to offset income from non-passive activities, such as salaries.[43] A taxpayer may carry forward any disallowed passive-activity losses and use his or her excess losses in subsequent years to offset passive income.[44] A taxpayer may also carry forward disallowed passive-activity losses when there is a disposition of the passive activity, which generated the passive loss.[45] Therefore, § 469 of the Code does not permanently disallow the use of excess passive-activity losses, rather, it defers such use.

2. "Passive Activity" Defined

An activity qualifies as "passive" if it involves a trade or business in which "the taxpayer does not materially participate."[46] A taxpayer "materially participates" only by regularly, continuously, and

42. *Id.* § 469(a)(1)(A), (d)(1). A taxpayer calculates and nets the income and loss generated from each of a taxpayer's passive activities. *See id.* § 469(d)(1)–(2). If the passive-activity loss exceeds the passive-activity gain, the remaining passive-activity loss cannot be deducted in the current taxable year. *See id.* § 469(3)(2)(A). For an in-depth explanation of the mechanics of § 469 of the Code, see generally Bittker et al., *supra* note 27, at 697–729; Oberst, *supra* note 39; Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988); Brad D. Williams & John W. Cullins, *The Application of the First Set of Passive Loss Regulations to Partnerships*, 5 J. P'SHIP TAX'N 195 (1988).

43. For example, if a taxpayer participates in a passive activity and has a loss of $100, the taxpayer cannot use the $100 loss to offset the taxpayer's salary. Instead, the taxpayer would carry forward the $100 loss for use in subsequent years. I.R.C. § 469(b).

44. *Id.*

45. *Id.* § 469(b), (g).

> Disallowed "passive activity credits" are also carried forward to the taxpayer's next taxable year and are allowable in that year to the extent of the amount, if any, of income tax attributable to net income that the taxpayer derives from "passive activities." The carryforward process continues indefinitely. However, in the year that the taxpayer disposes of his entire interest in the "passive activity," he may offset the carryover losses (but not the carryover credits) attributable to that activity against nonpassive and portfolio income.

Oberst, *supra* note 39, at 644 (footnotes omitted) (citing I.R.C. § 469(b), (g)).

46. I.R.C. § 469(c)(1). *See id.* § 469(c)(6)(B) (expanding the definition of a trade or business to include any activity in which § 212 deductions are allowed); *see also id.* § 469(c)(5) (expanding the typical definition of trade or business to also include "any activity involving research or experimentation"); Treas. Reg. § 1.469-4(b)(1)(ii) (2011) (providing that the definition of trade or business also includes activities that "[a]re conducted in anticipation of the commencement of a trade or business"). *But see* I.R.C. § 469(c)(2), (c)(7), (i) (providing that a rental activity is a "passive activity," but providing certain exceptions taxpayers involved in real estate). For an explanation of the exceptions for businesses involved in real estate, see Kalinka, *Part II: Unanswered Questions*, *supra* note 9, at 9.

substantially participating in the activity.[47] In order to prevent a taxpayer from using passive losses to shelter income from the typical forms of investment, such as dividends, interests, and capital gains from the sale of securities, Congress prohibited the consideration of net portfolio income when calculating income or loss arising from a passive activity.[48] While the congressional definition of "passive activity" left many practitioners with questions, Congress delegated to the IRS the power to promulgate regulations regarding the methods a taxpayer may use to demonstrate material participation.[49] Two years later, in 1988, the IRS promulgated Treasury Regulation § 1.469-5T, which set out seven separate tests for proving material participation.[50]

3. The Seven Factors of the Material-Participation standard

A taxpayer "materially participat[es] in an activity for the taxable year if and only if"[51]:

47. I.R.C. § 469(h)(1)(A)–(B).

48. *Id.* § 469(e)(1)(A)(i)(I)–(III). *See* S. REP. NO. 99-313, at 728 (1985) ("To permit portfolio income to be offset by passive losses . . . would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio."); *see also* Temp. Treas. Reg. § 1.469-2T(c)(3) ("Passive activity gross income does not include portfolio income.").

49. I.R.C. § 469(l)(1) ("The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations [] which specify what constitutes an activity, material participation, or active participation for purposes of this section . . . ."). While § 469(l) of the Code literally delegates the authority to write a regulation to "[t]he Secretary," the IRS usually drafts the regulation.

50. Income Tax, Limitations on Passive Activity Loss and Credits, 53 Fed. Reg. 5686 (Feb. 25, 1988) (to be codified at 26 C.F.R. pt. 1). The IRS promulgated § 1.469-5T as a temporary solution. T.D. 8175, 1988-1, C.B. 191. Current law mandates the expiration of such temporary regulations after three years. I.R.C. § 7805(e)(2). This limitation only applies to regulations promulgated after November 20, 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6232(b), 102 Stat. 3342, 3735 (1988). The IRS issued § 1.469-5T on February 25, 1988, so the three-year limitation does not apply. Brief for Defendant, *supra* note 12, at 12 (stating that Treasury Regulations § 1.469-5T "was finalized"). The government's brief further observes that:

> Amendments to Temp. Treas. Reg. § 1.469-5T and a corresponding notice of proposed rulemaking were published in the Federal Register on May 12, 1989. Written comments were received on the amendments to the temporary regulations, and a public hearing was held on November 28, 1989. To avoid possible disputes about whether the amendment to Temp. Treas. Reg. § 1.469-5T would "sunset" under § 7805(e)(2), [the] Treasury released a decision on May 11, 1992 adopting the amendments as final regulations, and preserving the cross references to the corresponding temporary regulations.

Id. at 12 n.8 (citations omitted).

51. Temp. Treas. Reg. § 1.469-5T(a).

(1) The individual participates in the activity for more than 500 hours during such year;[52]

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals . . . for such year;[53]

(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 . . . for such year;[54]

(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;[55]

(5) The individual materially participated in the activity . . . for any five taxable years . . . during the ten taxable years that immediately precede the taxable year;[56]

(6) The activity is a personal service activity . . . , and the individual materially participated in the activity for any three taxable years . . . preceding the taxable year;[57] 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.[58]

---

52. *Id.* § 1.469-5T(a)(1).

53. *Id.* § 1.469-5T(a)(2).

54. *Id.* § 1.469-5T(a)(3).

55. *Id.* § 1.469-5T(a)(4). A "significant participation activity" is a trade or business activity in which the taxpayer participates for more than 100 hours during such year. *Id.* § 1.469-5T(c)(1)–(2).

56. *Id.* § 1.469-5T(a)(5).

57. *Id.* § 1.469-5T(a)(6). A "personal service activity" is an "activity involv[ing] the performance of personal services in[:] (1) [t]he fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (2) [a]ny other trade or business in which capital is not a material income-producing factor." *See id* § 1.469-5T(d).

58. *Id.* § 1.469-5T(a)(7). While the regulation has yet to enumerate what facts and circumstances should be considered, it has provided some guidance. *See id.* § 1.469-5T(b)(2)(ii) (limiting the management activities that can be counted under the facts-and-circumstances test); *id.* § 1.469-5T(b)(2)(iii) (providing that if a taxpayer participates 100 hours or less in an activity, the taxpayer cannot be treated as materially participating under the facts and circumstances test).

Work done by the taxpayer as an investor in the activity, however, is not included when determining if the taxpayer materially participates "unless the individual is directly involved in the day-to-day management or operations of the activity."[59] If the taxpayer can meet one of the seven factors enumerated above, § 469 of the Code will not prevent the taxpayer from deducting a loss.[60] Still, the taxpayer would have to look to the at-risk rules of § 465 of the Code,[61] the related taxpayer rules of § 267 of the Code,[62] and other various tax rules regarding the deduction of losses.[63] If, however, the taxpayer is a limited partner, the taxpayer does not get all seven bites at the apple.

4. Section 469(h)(2) of the Code: The Limited-Partner Limitation

In the case of partnerships, the rules governing passive-activity loss apply at the partner level rather than the entity level.[64] If a taxpayer is a limited partner, then presumably the taxpayer is not materially participating in the partnership's activity.[65] Specifically, § 469(h)(2) of

---

59. *Id.* § 1.469-5T(f)(2)(ii).

60. *See* I.R.C. § 469(a), (c)(1)(B) (2006) (providing that a passive activity is one in which a taxpayer does not materially participate and for which passive-activity losses and credits are disallowed). *See also id.* § 469(h)(5) (providing that in determining whether a taxpayer materially participates, the participation of the taxpayer's spouse can be considered).

61. *Id.* § 465(a)(1) (disallowing losses deemed not "at-risk" by the taxpayer). *See* Temp. Treas. Reg. § 1.469-2T(d)(6) (coordinating §§ 465 and 469 of the Code as well as other loss-limitation provisions). For an in-depth explanation of the mechanics of § 465, see generally Bittker et al., *supra* note 27, at 684–96; Kalinka *Part II: Unanswered Questions*, *supra* note 9, at 9, 17–20.

62. I.R.C. § 267(a)(1), (6) (disallowing deduction of a loss in a transaction between related parties). For an in-depth explanation of mechanics of § 267 of the Code, see generally Robert I. Keller, *At a Loss: A Half Century of Confusion in the Tax Treatment of Transfers of Depreciated Property Between Related Taxpayers*, 44 TAX LAW. 445 (1991).

63. *See, e.g.*, I.R.C. § 165(a), (c)(1)–(3) (allowing individuals to only deduct losses incurred in a trade or business, a transaction entered into for profit, casualty losses, and theft losses); *id.* § 704(d) (allowing a partner to deduct a loss from a partnership only up to the amount of the partner's basis in the partnership).

64. *See* Temp. Treas. Reg. § 1.469-2T(e)(1) (providing that material participation is characterized with reference to each particular partner's participation); Treas. Reg. § 1.469-4(d)(5)(i)–(ii) (providing that material participation must be analyzed on an activity-by-activity basis, unless the taxpayer elects to combine all of its activities).

65. I.R.C. § 469(h)(2). The report includes additional guidance:

> Regardless of whether an individual directly owns an interest in a trade or business activity (e.g., as a proprietorship), or owns an interest in an activity conducted at the entity level by a passthrough entity such as a general partnership or S corporation, he must be involved in the operations of the activity on a regular, continuous, and substantial basis, in order to be materially participating.

S. REP. NO. 99-313, at 720 (1985).

the Code provides that "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."[66] Under the Treasury Regulations, instead of the material-participation standard enumerated above, a more stringent standard applies when determining whether a limited partner materially participates.[67] A limited partner who meets one of the following three factors qualifies as materially participating in the activity and avoids the passive-loss rules:

> (1) The individual participates in the activity for more than 500 hours during such year;
>
> . . . .
>
> (5) The individual materially participated in the activity . . . for any five taxable years . . . during the ten taxable years that immediately precede the taxable year; or
>
> (6) The activity is a personal service activity . . . , and the individual materially participated in the activity for any three taxable years . . . preceding the taxable year.[68]

Consequently, a limited partner's activity is per se passive unless the limited partner participates for more than 500 hours during the current year or the requisite prior years. This is especially disadvantageous for limited partners participating in start-up businesses—which typically generate losses in the formative years of the business—because the limited partner is able to meet only the first factor if the activity does not occur in previous years.

The material-participation standard, however, does not apply if the limited partner is also a general partner according to the general-partner exception.[69] Under this exception, a limited partner who is also a general

66. I.R.C. § 469(h)(2).

67. *See* Temp. Treas. Reg. § 1.469-5T(e)(1)–(2) (describing circumstances when "individual[s] shall not be treated as materially participating in any activity" when applying § 469 of the Code and the exceptions thereto).

68. *Id.* § 1.469-5T(e)(2) (referring back to § 1.469-5T(a)).

69. *Id.* § 1.469-5T(e)(3)(ii).

> A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which

partner can use the material-participation standard.[70] Thus, when a taxpayer (1) is both a general partner and a limited partner in a partnership, and (2) meets any of the seven factors, the taxpayer is treated as materially participating with respect to both the taxpayer's general and limited partnership interests.[71]

III. THE EVOLUTION OF THE LIMITED PARTNERSHIP AND LIMITED LIABILITY ENTITIES

The Code defines "partnership" as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a trust or estate or a corporation."[72] For tax purposes, a

> the individual (directly or indirectly) owns such limited partnership interest).

Id.

70. *Id.*

71. *Id.* (providing that the partner must be both a general and limited partner throughout the course of the taxable year). This provision seems to contradict the legislative history, which provides:

> When a taxpayer possesses both a limited partnership interest and another type of interest, such as a general partnership interest, with respect to an activity, lack of material participation is conclusively presumed with respect to the limited partnership interest (thus limiting the use of deductions and credits allocable thereto). The presence of material participation for purposes of any other interests in the activity owned by the taxpayer is determined with reference to the relevant facts and circumstances.

S. REP. NO. 99-313, at 731 (1985). Congress appears to have intended that, under the general-partner exception, only the taxpayer's general partner interest was evaluated under the material-participation standard. The taxpayer's limited partner interest should have been still subject to the more stringent standard. *But see* Michael J. Grace, *Passthrough Entities: Courts Confused About Passive Activity Material Participation Standards For Limited Liability Companies, but Regulations Could Use Updating*, DAILY RPT. FOR EXECUTIVES, June 29, 2010, at J-1. Grace, the "principal author" of Treasury Regulation § 1.469-5T, explains the reason for the general-partner exception regulation being more generous than the suggested Congressional guidelines:

> The regulations do not precisely follow those guidelines for a number of reasons. Most significantly, as previously explained, Congress's stated rationale for generally treating a limited partner as per se passive was limited liability under state law. Under non-tax law, however, a limited partner also owning a general partner interest in the same partnership loses the protection of limited liability. Such a partner can be held accountable, beyond contributed capital, for obligations of the partnership.
>
> The legislative history's guideline also would have required rules (either original or by cross reference) on how to allocate income, gains, losses, deductions, and credits between limited partner and general partner interests in the same partnership for purposes of characterizing those flowthrough items under Section 469. Such rules would have proven difficult and time consuming to draft and probably even more challenging for partnerships to apply and IRS to enforce.

Id. (footnote omitted).

72. I.R.C. § 7701(a)(2).

business entity with two or more persons is within the partnership or corporation classification.[73] Conversely, under Treasury Regulation § 301.7701-3, otherwise known as the check-the-box regulation, the classification for unincorporated entities with two or more owners defaults to partnership.[74] Consequently, for tax purposes, limited liability entities are characterized as a partnership unless the entity affirmatively elects to be characterized as a corporation.

This treatment of limited liability entities as partnerships raises the question of whether interests in one of the limited liability entities are limited partners or general partners for tax purposes.[75] For purposes of § 469(h)(2) of the Code, the IRS's position that owners of interest in limited liability entities are limited partners is based on the premise that owners are subject to limited liability.[76] This Article, however, asserts

---

> In plain English, if an arrangement among men is not an arrangement which puts them all in the same business boat, then they cannot get into the same boat merely to seek the benefits of [partnership tax laws]. But if they are in the same business boat, although they may have varying rewards and varied responsibilities, they do not cease to be in it when the tax collector appears.

Comm'r v. Culbertson, 337 U.S. 733, 754 (1949) (Frankfurter, J., concurring).

73. Treas. Reg. § 301.7701-2(a). Specifically, Treasury Regulation § 301.7701-2(b) defines a corporation as:

> (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;
>
> (2) An association (as determined under § 301.7701-3);
>
> (3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;
>
> (4) An insurance company;
>
> (5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, or a similar Federal statute;
>
> (6) A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in § 1.892-2T;
>
> (7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and
>
> (8) Certain foreign entities.

Id. § 301.7701-2(b)(1)–(8) (citation omitted).

74. *Id.* § 301.7701-3(b). *See also* Rev. Rul. 95-55, 1995-2 C.B. 313 (ruling that a New York LLP is to be taxed as a partnership).

75. *See, e.g.*, STEVEN C. ALBERTY, ADVISING SMALL BUSINESSES § 7:7 (2005) ("Certain tax rules predate the widespread use of LLCs and assume all partners in a partnership are general or limited partners. Since LLC members can have limited liability like limited partners but management rights like general partners—their classification is in doubt for some purposes.").

76. *See* discussion *infra* Part IV.A–C.

> The references in the regulations to "partnership" transcend state law, also encompassing entities not formed as partnerships under state law but classified as partnerships for

that § 469(h)(2) of the Code was a matter of administrative convenience and was based on Congress's focus on limited partnerships and a limited partner's inability to participate.[77] Thus, Part III will examine the relationship between limited liability and participation rights of owners in both limited partnerships and limited liability entities.

A. *The Limited Partnership*

1. The Origin of the Limited Partnership and Its Nonparticipation Requirement

In 1822, New York adopted the first limited partnership act.[78] Over the following thirty years, many other states adopted similar, if not identical, acts.[79] The limited partnership acts "encourage[d] trade by authorizing and permitting a capitalist to put his money into a partnership with general partners possessed of skill and business character only, without becoming a general partner, or hazarding anything in the business except the capital originally subscribed."[80] Thus, the foundation of the original limited partnerships acts consisted of two fundamental principles:

> First: That a limited . . . partner is a partner in all respects like [any other] partner, except that to obtain the privilege of a limitation on his liability, he has conformed to the statutory requirements in respect to filing a certificate and *refraining from participation in the conduct of the business*.

> federal tax purposes. By integrating principles of state law and tax law, the regulations in effect prescribe that a member of a LLC (or other partnership entity that limits the interest owner's liability to actual or agreed capital contributions) may materially participate in an activity only by satisfying any of the three regulatory tests available to a limited partner per se.

Grace, *supra* note 71.

77. *See* discussion *infra* Part IV.A.

78. Act of April 17, 1822, ch. 244, 1822 N.Y. Laws 259. *See also* UNIF. LTD. P'SHIP ACT official cmt. (1916) (noting that the original limited partnership statutes were derived from the French *Societé en Commandite*).

79. UNIF. LTD. P'SHIP ACT official cmt. (1916) (describing how "the other commercial states" followed New York's example). *See also* Janet L Eifert, Note, *Removal of General Partners: A Method of Intrapartnership Dispute Resolution for Limited Partnerships*, 39 VAND. L. REV., 1407, 1410 (1986); Mitchell A. Stephens, Comment, *A Trap for the Rational: Simultaneous Removal and Appointment of a General Partner Under the Revised Uniform Limited Partnership Act*, 2007 UTAH L. REV. 521, 522 (2007) ("[B]y the early 1900s every state in the union has passed similar legislation." (citing FRANCIS M. BURDICK, THE LAW OF PARTNERSHIP INCLUDING LIMITED PARTNERSHIPS 384 (2d ed. 1906)).

80. Clapp v. Lacey, 35 Conn. 463, 466 (1868).

> Second: The limited partner, on any failure to follow the requirements in regard to the certificate or any participation in the conduct of his business, loses his privilege of limited liability and becomes, as far as those dealing with the business are concerned, in all respects a partner.[81]

Accordingly, in order for limited partners to maintain their limited-liability shield, they were strictly prohibited from participating.

Prior to these acts, however, the courts had held that any person with an interest in a partnership would bear liability for the partnership's obligations.[82] Therefore, the courts only reluctantly allowed limited liability for limited partners and, in turn, narrowly construed the acts and required strict compliance.[83] The acts intended to provide an alternative business form, which provided limited liability to certain investors.[84] Unfortunately, these original acts lacked "practical usefulness."[85]

In 1916, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Limited Partnership Act (Act of 1916) to address the shortcomings of the original acts.[86] The Act of 1916 clearly defined a limited partnership as an entity having at least one general partner and one or more limited partners who filed a certificate.[87] Unlike the original acts, the Act of 1916 afforded protection to a limited partnership that had substantially complied "in good faith with the requirements."[88]

The Act of 1916 preserved the foundation of the original acts by providing that a limited partner would "not be bound by the obligations

---

81. UNIF. LTD. P'SHIP ACT official cmt. (1916) (emphasis added).

82. *Id. See* Grace v. Smith, (1775) 96 Eng. Rep. 587 (K.B.) 588 ("Every man who has a share of the profits of a trade ought also to bear his share of the loss."); Wendell M. Basye, *A Survey of the Limited-Partnership Form of Business Organizations*, 42 OR. L. REV. 35, 36 (1962) ("This doctrine of the liability to third persons of anyone who shared the profits of a trade . . . became recognized in this country." (citing 1 SCOTT ROWLEY, THE MODERN LAW OF PARTNERSHIPS § 51 (1916))). *See generally* Stephens, *supra* note 79, at 522–26 (providing a history of limited partnerships).

83. UNIF. LTD. P'SHIP ACT official cmt. (1916).

84. *Id.*

85. *Id.*

> One of the causes forcing business into the corporate form, in spite of the fact that the corporate form is ill suited to many business conditions, is the failure of the existing limited partnership acts to meet the desire of the owners of a business to secure necessary capital under the existing limited partnership form of business association.

Id.

86. *Id.* (asserting that there existed a "failure of the . . . limited partnership acts to meet the desire of the owners of a business").

87. *Id.* §§ 1–2.

88. *Id.* § 2.

of the partnership."[89] Limited partners also would preserve their limited-liability shield as long as they did not "take part in the control of the business."[90] A limited partner did, however, have the right to (1) inspect and copy the partnership books, (2) demand truthful and full disclosure of information, including "a formal account of partnership affairs whenever circumstances render it just and reasonable," (3) demand a court decree for dissolution and winding up, and (4) receive "a share of the profits or other compensation."[91] Thus, general partners manage the partnership and have personal liability; conversely, limited partners are passive investors with limited liability. The Act of 1916 constituted "a law that provided greater protection for limited partners and was almost uniformly adopted."[92]

2. The Evolution of the Participation Rights of a Limited Partner

a. The Revised Uniform Limited Partnership Act of 1976: Weakening the Nonparticipation Requirement

Sixty years later, in an effort to modernize the Act of 1916, the National Conference of Commissioners on Uniform State Laws adopted the Revised Uniform Limited Partnership Act of 1976 (Act of 1976).[93] This revision preserved the requirement that precluded a limited partner from both "tak[ing] part in the control of the business" and enjoying the protections of limited liability.[94] Most importantly, the Act of 1976

89. *Id.* § 1.

90. *Id.* § 7 ("A limited partner shall not become liable as a general partner unless . . . he takes part in the control of the business."). However,

> [a] limited partner is liable to the partnership
>
> (a) [f]or the difference between his contribution as actually made and that stated in the certificate as having been made, and
>
> (b) [f]or any unpaid contribution which he agreed in the certificate to make in the future at the time and on the conditions stated in the certificate.

Id. § 17(1). Furthermore, a limited partner is liable for any amount of return on capital from the partnership "necessary to discharge [the limited partnership's] liabilities to all creditors who extended credit or whose claims arose before such return." *Id.* § 17(4).

91. *Id.* § 10(1)–(2). *See also id.* § 13 (providing that a limited partner may also "loan money to and transact other business with the partnership").

92. Stephens, *supra* note 79, at 522 (citing UNIF. LTD. P'SHIP ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 6 U.L.A. 49 (Supp. 1973)).

93. REV. UNIF. LTD. P'SHIP ACT prefatory note (1976).

94. *Compare id.* § 303(a) (1976), *with* UNIF. LTD. P'SHIP ACT § 7 (1916).

added a non-exhaustive list of activities[95] in which a limited partner could participate without losing the limited-liability shield.[96]

Moreover, the Act of 1976 restricted liability of a limited partner who "merely step[ped] over the line of participation in control" to only those creditors who had actual knowledge of such participation.[97] "However, these protections were complicated by a countervailing rule which made a limited partner generally liable for the limited partnership's obligations 'if the limited partner's participation in the control of the business [was] . . . substantially the same as the exercise of the powers of a general partner.'"[98] Thus, the Act of 1976 allowed a limited partner to participate on a limited basis without losing his limited-liability shield.

95. REV. UNIF. LTD. P'SHIP ACT § 303(b) (1976). If a limited partner participates in one of the activities listed under section 303(b) of the Act of 1976, the limited partner does not necessarily lose his limited liability. *Id.* § 303(b); *see, e.g.*, *id.* § 303(b)(1) (allowing limited partners to be a "contractor for or an agent or employee of the limited partnership"); *id.* § 303(b)(2) (allowing a limited partner to consult with and advise a general partner "with respect to the business of the limited partnership"); *id.* § 303(b)(3) (allowing a limited partner to act as a surety); *id.* § 303(b)(4) (allowing a limited partner to approve or disapprove amendments to the partnership agreement); § 303(b)(5)(i)–(v) (allowing a limited partner to vote on matters such as dissolution, winding up, and transfer of assets in the ordinary course of business, to incur indebtedness by the limited partnership other than in the ordinary course of business, to change the nature of the business, and to remove a general partner). "[T]he enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him in the business of the limited partnership." *Id.* § 303(c).

96. *Id.* § 303(a).

> Article 3 deals with the single most difficult issue facing lawyers who use the limited partnership form of organization: the powers and potential liabilities of limited partners. Section 303 lists a number of activities in which a limited partner may engage without being held to have so participated in the control of the business that he assumes the liability of a general partner.

Id. prefatory note. *But see id.* § 303(d) ("A limited partner who knowingly permits his name to be used in the name of the limited partnership, except under circumstances permitted by [s]ection l02(2)(i), is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.").

97. *Id.* prefatory note. A subsequent provision solidifies this notion by providing that "if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control." *Id.* § 303(a).

98. UNIF. LTD. P'SHIP ACT § 303 cmt. (2001) (quoting REV. UNIF. LTD. P'SHIP ACT § 303(a) (1976)).

b. The Revised Uniform Limited Partnership Act of 1985: Further Weakening the Nonparticipation Requirement

One year prior to the enactment of § 469(h)(2) of the Code, the National Conference of Commissioners on Uniform State Laws amended the Act of 1976.[99] In the continued effort to modernize the law surrounding limited partnerships, the 1985 changes did not supersede the Act of 1976, but instead were incorporated into the Act of 1976—creating the Revised Uniform Partnership Act of 1985 (Act of 1985).[100] The Act of 1985 made almost no changes to the basic structure of the Act of 1976; however, it did substantially expand the non-exhaustive list of activities in which limited partners could participate without losing their limited-liability shield.[101] Under the Act of 1985, a limited partner, in addition to the list in the Act of 1976, could participate in many more activities without being deemed to participate in the control of the limited partnership.[102]

The Act of 1985 further strengthened the limited-liability shield by removing the "substantially the same" requirement found in section 303(a) of the Act of 1976.[103] Moreover, the Act of 1985 provided that "if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's

99. REV. UNIF. LTD. P'SHIP ACT prefatory note (1985) (discussing the history of the Uniform Limited Partnership Act.)

100. *Id.*

101. *Id.* ("This 'detrimental reliance' test, together with an expansion of the 'laundry list' of specific activities in which limited partners may participate without incurring liability, are among the principal innovations in the 1985 Act."); *id.* § 303 cmt. ("This 'safe harbor' list has been expanded beyond that set out in the 1976 Act to reflect case law and statutory developments and more clearly to assure that limited partners are not subjected to general liability where such liability is inappropriate.").

102. *See, e.g.*, *id.* § 303(b)(1) (allowing limited partners to be officers, directors, or shareholders of a general partner that is a corporation); *id.* § 303(b)(3) (allowing limited partners to guarantee or assume obligations of the limited partnership); *id.* § 303(b)(4) (allowing limited partners to "tak[e] an action required or permitted by law to bring or pursue a derivative action"); *id.* § 303(b)(5) (allowing limited partners to "request[] or attend[] a meeting of partners"); *id.* § 303(b)(6)(iv)–(ix) (allowing limited partners to change the nature of the business, add or remove general or limited partners, vote on or approve a transaction involving a potential conflict of interest, amend the partnership agreement or certificate, and vote on or approve all matters related to the business of the limited partnership not otherwise enumerated); *id.* § 303(b)(7) (allowing limited partners to wind up the partnership); *id.* § 303(b)(8) (allowing limited partners to exercise rights not enumerated under section 303 of the Act).

103. *Compare* REV. UNIF. LTD. P'SHIP ACT § 303(a) (1976), *and supra* note 98 and accompanying text, *with* REV. UNIF. LTD. P'SHIP ACT § 303(a) (1985).

conduct, that the limited partner is a general partner."[104] Thus, the Act of 1985 allowed a limited partner substantial latitude to participate in the limited partnership without losing the limited-liability shield.

c. Uniform Limited Partnership Act of 2001: Removal of the Nonparticipation Requirement

Although weakened by each revision, the participation standard had been the mainstay of the limited partnership acts for the last 189 years. In 2001, however, the National Conference of Commissioners on Uniform State Laws introduced the Uniform Limited Partnership Act of 2001 (the Act of 2001), which removed the lack-of-participation standard so that a limited partner retained the limited-liability shield regardless of his level of participation.[105] Section 303 of the Act of 2001 states:

> An obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. *A limited partner is not personally liable*, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, *even if the limited partner*

---

104. REV. UNIF. LTD. P'SHIP ACT § 303(a) (1985). *See also* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT (2001) § 5.02(b), at 201 (2011 ed. 2011) ("The 'control rule' normally has little impact because [the Act of 1985] provides for a creditor reliance requirement, as well as broad safe harbors that permit extensive limited partner control through positions in corporate general partners and otherwise." (citing UNIF. LTD. P'SHIP ACT § 303(b) (1985))).

105. *See* UNIF. LTD. P'SHIP ACT § 303 (2001). The Act of 2001 continues:

> The shield established by this section protects only against liability for the limited partnership's obligations and only to the extent that the limited partner is claimed to be liable on account of being a limited partner. Thus, a person that is both a general and limited partner will be liable as a general partner for the limited partnership's obligations. Moreover, this section does not prevent a limited partner from being liable as a result of the limited partner's own conduct and is therefore inapplicable when a third party asserts that a limited partner's own wrongful conduct has injured the third party. This section is likewise inapplicable to claims by the limited partnership or another partner that a limited partner has breached a duty under this Act or the partnership agreement.
>
> This section does not eliminate a limited partner's liability for promised contributions or improper distributions. That liability pertains to a person's status as a limited partner but is not liability for an obligation of the limited partnership.

Id. § 303 cmt. (citations omitted).

Prior to the 2001 revision, the limited partnership acts were linked to the Uniform Partnership Act. Daniel S. Kleinberger, *A User's Guide to the Uniform Limited Partnership Act*, 37 SUFFOLK U. L. REV. 583, 584–88 (2004). Despite a de-linking effort in 2001, some overlap remains. *Id.*

> *participates in the management and control of the limited partnership.*[106]

The Act of 2001 eliminates the participation standard because, "[a]lthough this [nonparticipation requirement] is subject to a lengthy list of safe harbors in a world with [limited liability entities], the rule is an anachronism."[107] To rectify this, the Act of 2001 "eliminates the [nonparticipation requirement] and provides a full, status-based shield against limited partner liability for entity obligations."[108] Thus, under the Act of 2001, a limited partner retains his limited-liability shield even when participating in the control of the limited partnership.[109]

As of July 2011, eighteen states and the District of Columbia had adopted the Act of 2001.[110] The remaining states, except for Louisiana, have at least adopted, with or without modification, the Act of 1985.[111] Thus, in today's business environment, the nonparticipation requirement of a limited partnership is either eliminated or substantially weakened.

B. The Limited Liability Company

1. The Origin of the LLC

In 1977, the United States witnessed the dawn of the LLC when Wyoming passed the first LLC statute.[112] Much uncertainty existed, however, regarding the tax treatment of the new entity.[113] In 1980, the

---

106. UNIF. LTD. P'SHIP ACT § 303 (emphasis added).

107. *Id.* prefatory note.

108. *See id.* (citations omitted).

109. *Id.* § 303. *See also id.* § 302 ("A limited partner does not have the right or the power as a limited partner to act for or bind the limited partnership."). *But see id.* § 302 cmt. (providing that "the partnership agreement may . . . allocate managerial rights to one or more limited partners").

110. UNIF. LAW COMM'N, Nat'l Conference of Comm'rs on Unif. State Laws, *Legislative Fact Sheet—Limited Partnership Act*, http://www.nccusl.org (last visited Aug. 19, 2011) (indicating that the Act of 2001 has been adopted by Alabama, Arkansas, California, the District of Columbia, Florida, Hawaii, Idaho, Illinois, Iowa, Kentucky, Maine, Minnesota, Montana, Nevada, New Mexico, North Dakota, Oklahoma, Utah, and Washington).

111. J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIP § 18.1 (Supp. 2009).

112. Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws 537 (codified as amended at WYO. STAT. ANN. §§ 17-29-101 to -147 (West 2007)). *See* Joseph P. Fonfara & Corey R. McCool, Comment, *The Wyoming Limited Liability Company: a Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523, 523 (1988) (stating that as of 1988 there were only twenty-six Wyoming LLCs).

113. In 1998, Treasury Regulations known as the "Kintner Regulations" adopted "a four-factor analysis to determine whether an LLC or other noncorporate entity was to be classified as a

IRS published a proposed regulation, which would have effectively taxed an LLC as a corporation.[114] The day after the issuance of the proposed regulations, however, the IRS issued a private-letter ruling indicating that an LLC is subject to partnership taxation.[115] Amidst the uncertainty, Florida adopted the second LLC statute in 1982.[116] Then, in late 1982, the IRS withdrew the aforementioned proposed regulations due to their overwhelming criticism.[117] The IRS then launched a study to determine the proper tax classification of an LLC.[118]

---

partnership or as an association taxable as a corporation." Steven C. Alberty, *What You Should Know About The Taxation of Limited Liability Companies*, 18 PRAC. TAX LAW, Winter 2004, at 45, 47. Under this four-factor analysis, an entity was treated as an association for tax purposes if three or more of the following four characteristics existed: (1) limited liability; (2) centralized management; (3) free transferability of interest; and (4) continuity of life. *Id.* An LLC met the limited-liability factor and the centralized management factor if it was manager-managed. *Id.* If the LLC was freely transferable or had continuity of life, the LLC would be taxed as a partnership. *Id.* However, in 1997, the promulgation of the check-the-box regulations removed the uncertainty regarding the taxation of an LLC. *Id.* at 47–48. *See supra* note 74 and accompanying text (discussing the check-the-box regulations). *See also* Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 212–21 (2004) (discussing the evolution and history of the check-the-box regulations).

114. Classification of Limited Liability Companies, 45 Fed. Reg. 75,709, 75,709–10 (Nov. 17, 1980).

> The proposed regulations provide that an organization with associates and a joint profit objective shall be classified as an association if no member is personally liable for debts of the organization under local law. The Internal Revenue Service believes that the term "partnership" can apply only to an organization some member of which is personally liable under applicable local law for debts of the organization. Since a limited liability company does not satisfy this condition, it cannot be classified as a partnership.

Id.

115. I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). The IRS acknowledged a remaining issue by noting:

> On November 17, 1980, proposed regulations were published which amended the regulations concerning classification of organizations. The proposed regulations provide that an organization in which no member has personal liability for the debts of the organization be classified as an association taxable as a corporation. For organizations that have begun business on or before November 17, 1980, the proposed regulations are effective for taxable years beginning after December 31, 1982.

Id.

116. Florida Limited Liability Company Act, ch. 82-177, 1982 Fla. Laws 580 (codified as amended at FLA. STAT. ANN. §§ 608.401.705 (West 2007)).

117. I.R.S. News Release IR-82-145 (Dec. 16, 1982). The IRS published the notice in the *Federal Register*. Withdrawal of Notice of Proposed Rulemaking for Classification of Limited Liability Companies, 48 Fed. Reg. 14,389, 14,389–90 (April 4, 1983) ("This document withdraws the notice of proposed rulemaking that appeared in the Federal Register on November 17, 1980 (45 FR 75,709).").

118. Withdrawal of Notice of Proposed Rulemaking for Classification of Limited Liability Companies, 48 Fed. Reg. at 14,390 (April 4, 1983) (stating that "[t]he [IRS] is undertaking a study of the rules for the classification of entities").

In 1988, the IRS completed the project and published its findings in a Revenue Ruling.[119] In the ruling, the IRS announced that it would treat a Wyoming LLC as a partnership for tax purposes.[120] Thus, beginning in the early 1990s and following the resolution of the proper tax treatment of an LLC, the remaining states and the District of Columbia adopted LLC statutes.[121]

2. Lack of a Nonparticipation Requirement, but Limited Liability

An LLC preserves each member's limited-liability status even if the individual member participates in the management and daily activities of the LLC.[122] Additionally, the LLC members still enjoy the benefits of partnership treatment for the purpose of federal income tax. Although LLC members have the right to participate in the management of the LLC, not all members exercise such authority. Accordingly, LLCs may be divided into two types—member-managed and manager-managed.[123]

---

119. Rev. Rul. 88-76, 1988-2 C.B. 360. *But see* Rev. Rul. 98-37, 1998-2 C.B. 133 (providing that Revenue Ruling 88-76, "although not specifically revoked or superseded, [is] no longer considered determinative" and, therefore, is "declared obsolete").

120. Rev. Rul. 88-76, 1988-2 C.B. 360. *See also* I.R.S. Priv. Ltr. Rul. 89-37-010 (Sept. 15, 1989) (treating a Florida LLC as a partnership for tax purposes).

121. REV. UNIF. LTD. LIAB. CO. ACT prefatory note (2006) ("All states and the District of Columbia have adopted LLC statutes, and many LLC statutes have been substantially amended several times.").

122. *Id.* § 304(a). Section 304(a) states:

> (a) The debts, obligations, or other liabilities of a limited liability company, whether arising in contract, tort, or otherwise:
>
> (1) are solely the debts, obligations, or other liabilities of the company; and
>
> (2) do not become the debts, obligations, or other liabilities of a member or manager solely by reason of the member acting as a member or manager acting as a manager.

Id. *See also* Mary Elizabeth Matthews, *The Arkansas Limited Liability Company: A New Business Entity Is Born*, 46 ARK. L. REV. 791, 794 (1994) (stating that management of an LLC "is specifically vested in the members unless granted to a manager").

123. REV. UNIF. LTD. LIAB. CO. ACT § 407(a). Section 407(a) states:

> (a) A limited liability company is a member-managed limited liability company unless the operating agreement:
>
> (1) expressly provides that:
>
> (A) the company is or will be "manager-managed";
>
> (B) the company is or will be "managed by managers"; or
>
> (C) management of the company is or will be "vested in managers"; or
>
> (2) includes words of similar import.

Id. *Compare id.* § 102(10) ("'Manager-managed limited liability company' means a limited liability company that qualifies under section 407(a)."), *with id.* § 102(12) ("'Member-managed limited liability company' means a limited liability company that is not a manager-managed limited liability company.").

In a member-managed LLC, the members holding voting interests essentially manage the business affairs of the LLC because they have authority to act on behalf of the LLC.[124] Moreover, the members each have equal rights in the management and conduct of the company's activities unless the membership agreement specifies otherwise.[125] Alternatively, in a manager-managed LLC, the members elect the manager(s), thereby vesting the authority to manage and operate the LLC in a person or a group of persons.[126] Consequently, the members of a manager-managed LLC could elect to vest the managerial authority in a member or in an outside third party.[127] Thus, the LLC members have a range of management roles from active participant to passive investor.

---

124. *Id.* § 407(b)(1) ("In a member-managed limited liability company . . . [t]he management and conduct of the company are vested in the members."). Additionally, a member of a member-managed LLC can avoid participating in the management pursuant to the membership agreement. *See* Matthews, *supra* note 122, at 794.

125. REV. UNIF. LTD. LIAB. CO. ACT § 407(b)(2)–(5). Section 407(b)(2)–(5) states:

> (b) In a member-managed limited liability company, the following rules apply:
>
> . . . .
>
> (2) [e]ach member has equal rights in the management and conduct of the company's activities[;]
>
> (3) [a] difference arising among members as to a matter in the ordinary course of the activities of the company may be decided by a majority of the members[;]
>
> (4) [a]n act outside the ordinary course of the activities of the company may be undertaken only with the consent of all members[;]
>
> (5) [t]he operating agreement may be amended only with the consent of all members.

Id.

126. *Id.* § 407(c). Section 407(c) states:

> (c) In a manager-managed limited liability company, the following rules apply:
>
> (1) [e]xcept as otherwise expressly provided in [the Act], any matter relating to the activities of the company is decided exclusively by the managers[;]
>
> (2) [e]ach manager has equal rights in the management and conduct of the activities of the company[;]
>
> . . . .
>
> (5) A manager may be chosen at any time by the consent of a majority of the members and remains a manager until a successor has been chosen . . . .

Id.

127. *Id.* § 407(c)(6). Section 407(c)(6) states:

> A person need not be a member to be a manager, but the dissociation of a member that is also a manager removes the person as a manager. If a person that is both a manager and a member ceases to be a manager, that cessation does not by itself dissociate the person as a member.

Id.; *see also id.* § 102(9) ("'Manager' means a person that under the operating agreement of a manager-managed limited liability company is responsible, alone or in concert with others, for performing the management functions stated in [s]ection 407(c).").

Ultimately, an LLC member maintains his limited-liability shield regardless of the member's level of participation.

C. The Limited Liability Partnership

1. The Origin of the LLP

In 1991, in response to the large amount of losses to general partnerships incurred because of the savings-and-loan scandals of the 1980s, Texas created the LLP.[128] Reacting to the losses sustained in malpractice suits derived from the savings-and-loan scandal, a small Texas law firm first proposed the idea of an LLP.[129] Unlike a general partnership, where each general partner is personally liable for partnership obligations that exceed the assets of the partnership, the firm intended to create a general partnership with limited liability.[130]

Soon after the incorporation of the law firm's idea into a Texas senate bill, partnership expert Professor Alan R. Bromberg assisted with revisions[131] because the bill drew criticism for various reasons and was

---

128. Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COL. L. REV. 1065, 1069 (1995) ("The LLP is a direct outgrowth of the collapse of real estate and energy prices in the late 1980s, and the concomitant disaster that befell Texas's banks and savings and loan associations."). *See also* Susan Saab Fortney, *Seeking Shelter in the Minefield of Unintended Consequences—The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717, 724 (1997) (citing Hamilton, *supra*, at 1069); Kelly L. Jones, Comment, *Law Firms as Limited Liability Partnerships: Determining the Scope of the Limited Liability Shield: A Shield of Steel or Silk?*, 7 DUQ. BUS. L.J. 21, 22–24 (2005). *See generally* BROMBERG & RIBSTEIN, *supra* note 104, § 1.01(a)–(c), at 3–15 (discussing the history of the LLP).

129. Fortney, *supra* note 128, at 724. Professor Fortney further observed:

> Following the failure of a number of Texas financial institutions, banking regulators pursued actions against the institutions' officers, directors, and professional advisers, including the institutions' former counsel. These claims captured the attention of the legal community because the amount of alleged damages far exceeded the amount of the insurance coverage carried by the target law firms. Attorneys could not fathom the possibility of their personal, nonexempt assets being subject to execution for judgment arising from their partners' malpractice. This concern spurred attorneys' interest in seeking legislative changes to limit their vicarious liability.
>
> Partners of a twenty-one person Lubbock Texas law firm originated the idea of a changing partnership law to limit professionals' vicarious liability.

Id.

130. *See* Hamilton, *supra* note 128, at 1067 ("In the original LLP concept, all partners have the benefits, responsibilities, and potential liability of general partners except that partners have no responsibility for malpractice claims . . . .").

131. Fortney, *supra* note 128, at 725 ("Professor Bromberg's revisions addressed objections to the bill . . . ."). *See also* Hamilton, *supra* note 128, at 1073–74 (providing that Bromberg "originally criticized the [bill] . . . but nevertheless later agreed to take the principal drafting responsibility for revising [the bill] to make it more acceptable").

called by some a "'help-a-lawyer[]bill.'"[132] Bromberg addressed objections to the bill by:

> (1) [e]xtending the liability limitation to all partnerships[;]
>
> (2) [d]enying protection to partners for misconduct of those working under their supervision or direction[;]
>
> (3) [r]equiring annual registration with the state and inclusion of "L.L.P." or "registered limited liability partnership," in the firm name[;] and
>
> (4) [r]equiring liability insurance in an arbitrary and admittedly often inadequate amount of $100,000.[133]

With Bromberg's revisions, the state legislature amended the Texas Uniform Partnership Act, and the first LLP was born.[134] Soon thereafter, many states enacted similar laws, creating a state-statutory LLP.[135] These state LLP laws, however, were "far from uniform."[136] Accordingly, in 1996, the 1994 Revised Uniform Partnership Act[137] was

---

132. Fortney, *supra* note 128, at 724–25 (quoting Hamilton, *supra* note 128, at 1069). The bill received further criticism for "only cover[ing] professionals" and "reliev[ing] parties of responsibility for the misconduct of persons they directed and supervised, fail[ing] to signal to third parties that the new entity limited liability, and fail[ing] to provide a substitute source of recovery (i.e., insurance)." *Id.* (citing ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 1.01(a), at 3 (1995)). *See also* Hamilton, *supra* note 128, at 1073 (finding that "the argument was strongly made that the bill was not needed, since law firms could become professional corporations and thereby limit their liability").

133. Fortney, *supra* note 128, at 725 (citing BROMBERG & RIBSTEIN, *supra* note 132, § 1.01(a), at 3–4).

134. Texas Unif. P'ship Act, ch. 901, 1991 Tex. Gen. Laws 3234 (codified as amended at TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 1.01–11.05 (West 2009), *expired pursuant to* TEX. REV. CIV. STAT. ANN. art. 6132b, § 11.05).

135. *See* BROMBERG & RIBSTEIN, *supra* note 132, § 1.01(b)–(e), at 10–17 (naming some states that have enacted LLP laws); *see also* BISHOP & KLEINBERGER, *supra* note 8, ¶ 15.01 (providing that "all states (except Vermont and Wyoming) and the District of Columbia have LLP laws").

136. BISHOP & KLEINBERGER, *supra* note 8, ¶ 15.01[2] ("Although most LLP laws are amendments to the Uniform Partnership Act (1994) . . . the LLP amendments are far from uniform.").

137. REV. UNIF. P'SHIP ACT (1994).

amended to create a uniform LLP statute.[138] Currently, all states have enacted legislation providing for an LLP.[139]

---

138. UNIF. LTD. LIAB. P'SHIP ACT (1996). *See* BISHOP & KLEINBERGER, *supra* note 8, ¶ 15.01[2]. Professors Bishop and Kleinberger have observed:

> The extreme variances in state law prompted the National Conference of Commissioners on Uniform State Laws in 1996 to promulgate Limited Liability Partnership amendments (ULLPA) to the Revised Uniform Partnership Act (1994) (RUPA). Only the Alabama, Arizona, California, Colorado, Connecticut, Florida, Maryland, Minnesota, Montana, New Mexico, North Dakota, Texas, Virginia, and West Virginia LLP statutes are based, at least in part, on RUPA and only the Arizona and Minnesota versions resemble the ULLPA amendments to the RUPA. Moreover, some states, like California, Nevada, New York and Oregon, only permit professionals to use a limited liability partnership.

Id. (footnote omitted).

139. *See* ALA. CODE §§ 10A-8-10.01 to .10 (1975); ALASKA STAT. ANN. §§ 32.06.912–.925 (West 2007); ARIZ. REV. STAT. ANN. §§ 29-1101 to -1109 (1998 & Supp. 2010); ARK. CODE ANN. §§ 4-46-1001 to -1003 (West 2006 & Supp. 2011); CAL. CORP. CODE §§ 16951–16962 (West 2006 & Supp. 2011); COLO. REV. STAT. ANN. §§ 7-60-144 to -154 (West 2006 & Supp. 2010); CONN. GEN. STAT. ANN. §§ 34-406 to -449 (West 2005 & Supp. 2011); DEL. CODE ANN. tit. 6, §§ 15-1001 to -1004 (West 2006 & Supp. 2011); D.C. CODE §§ 33-110.01 to .04 (2010 & Supp. 2011); FLA. STAT. ANN. §§ 620.9001–.9902 (West 2007 & Supp. 2011); GA. CODE ANN. §§ 14-8-62 to -64 (West 2003); HAW. REV. STAT. §§ 425-151 to -173 (West 2008 & Supp. 2010); IDAHO CODE ANN. §§ 53-3-1001 to -1003A (West Supp. 2011); 805 ILL. COMP. STAT. ANN. 206/1001–206/1003 (West 2010); IND. CODE ANN. §§ 23-4-1-44 to -53 (West 2005 & Supp. 2011); IOWA CODE ANN. §§ 486A.1001–.1002 (West 2009); KAN. STAT. ANN. §§ 56a-1001 to -1005 (2005 & Supp. 2010); KY. REV. STAT. ANN. §§ 362.555–.605 (West 2006 & Supp. 2011); LA. REV. STAT. ANN. §§ 9:3431–9:3435 (2009); ME. REV. STAT. ANN. tit. 31, §§ 801–830 (Supp. 2010); MD. CODE ANN., CORPS. & ASS'NS §§ 9A-1001 to -1016 (West 2002 & Supp. 2010); MASS. GEN. LAWS ANN. ch. 108A, §§ 45–49 (West 1999); MICH. COMP. LAWS ANN. §§ 449.44–.48 (West 2002); MINN. STAT. ANN. §§ 323A.1001–.1004 (West 2011); MISS. CODE ANN. §§ 79-13-1001 to -1002 (West Supp. 2010); MO. REV. STAT. §§ 358.440–.520 (West 2000 & Supp. 2011); MONT. CODE ANN. §§ 35-10-701 to -710 (2009); NEB. REV. STAT. §§ 67-454 to -456 (2009); NEV. REV. STAT. ANN. §§ 87.440–.540 (West 2005 & Supp. 2011); N.H. REV. STAT. ANN. §§ 304-A:44 to :55 (2005 & Supp. 2011); N.J. STAT. ANN. §§ 42:1A-47 to -49 (West 2004); N.M. STAT. ANN. §§ 54-1A-1001 to -1003 (West 2003); N.Y. P'SHIP LAW §§ 121-1500 to -1506 (McKinney 2006 & Supp. 2011); N.C. GEN. STAT. ANN. §§ 59-84.2 to .4 (West 2000 & Supp. 2010); N.D. CENT. CODE ANN. §§ 45-22-01 to -27 (West 2008 & Supp. 2010); OHIO REV. CODE ANN. §§ 1776.81–.84 (West 2009); OKLA. STAT. ANN. tit. 54, §§ 1-1001 to -1002 (West 2011); OR. REV. STAT. ANN. §§ 67.500–.680 (West 2003 & Supp. 2011); 15 PA. CONS. STAT. ANN. §§ 8201–8221 (West 1995 & Supp. 2011); R.I. GEN. LAWS ANN. §§ 7-12-56 to -59 (West 2006); S.C. CODE ANN. §§ 33-41-1110 to -1140 (2006); S.D. CODIFIED LAWS §§ 48-7A-1001 to -1004.1 (2004 & Supp. 2011); TENN. CODE ANN. §§ 61-1-1001 to -1006 (West 2002 & Supp. 2011); TEX. BUS. ORGS. CODE ANN. §§ 152.801–.805 (West 2010); UTAH CODE ANN. §§ 48-1-41 to -48 (West 2004 & Supp. 2011); VT. STAT. ANN. tit. 11, §§ 3291–3293 (West 2007); VA. CODE ANN. §§ 50-73.132 to .143 (West 2008 & Supp. 2011); WASH. REV. CODE ANN. §§ 25.05.500–.536 (West 2010); W. VA. CODE ANN. §§ 47B-10-1 to -5 (West 2002 & Supp. 2011); WIS. STAT. ANN. §§ 178.40–.53 (West 2006 & Supp. 2010); WYO. STAT. ANN. §§ 17-21-1101 to -1107 (West 2007 & Supp. 2011).

2. Lack of a Nonparticipation Requirement, but Limited Liability

An LLP is a general partnership that is generally subject to applicable provisions of the general partnership statute.[140] The only real difference between an LLP and a general partnership is that the LLP makes a filing to obtain limited liability for its general partners.[141] LLP partners may participate in management. Consequently, regardless of a member's level of participation, the partner maintains his limited-liability shield.[142]

D. The Limited Liability Limited Partnerships

1. The Origin of the LLLP

The enactment of the first LLLP statute was in 1995, with Texas again leading the way by adopting statutory language providing for an LLLP.[143] An LLLP is a limited partnership in which general partners and, under most state statutes, limited partners—even if they participate in the LLLP—are not liable to third parties for some or all partnership obligations.[144] In many states, the LLLP status is based not on a separate

---

140. *See* Hamilton, *supra* note 128, at 1067.

141. *See* CALLISON & SULLIVAN, *supra* note 111, § 14:11 (2011).

> A partner in a registered LLP is protected from personal liability for partnership debts and obligations arising from the errors, omissions, negligence, incompetence, or malfeasance committed in the course of partnership business by another partner or a partnership representative. Partnership assets remain subject to partnership liabilities, and the use of a registered LLP does not protect a partner from his or her own wrongful acts or from liability for partnership contractual obligations.

Id.

142. *See id.*

143. BISHOP & KLEINBERGER, *supra* note 8, ¶ 15.03[1]. "Texas provides that a limited partnership may become a registered limited liability partnership by complying with applicable provisions of [Texas law]." *Id.* (citing TEX. REV. CIV. STAT. ANN. art. 6132b, § 3.08(e) (West Supp. 1995), *expired pursuant to* TEX. REV. CIV. STAT. ANN. art. 6132b, § 11.05).

144. BROMBERG & RIBSTEIN, *supra* note 104, § 5.02(a), at 201 ("The general partners in an LLLP are liable to the same extent as general partners in an LLP.").

> A limited liability limited partnership . . . is a limited partnership that has invoked the limited liability limited partnership provisions of its state partnership law by filing with a specified public official a specified document, and thereby becoming a limited liability limited partnership and eliminating completely the automatic personal liability of each general partner for each partnership obligation and, under most statutes, also eliminating the "control rule" liability exposure for all limited partners.

Kleinberger, *supra* note 10, at 456 (citing JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 845 (6th ed. 2004)).

statutory scheme but, rather, on amendments to the law governing limited partnerships.[145] Other states, however, allow a limited partnership to register as an LLP, which effectively makes the limited partnership an LLLP.[146]

In 2001, following the trend of several states, the Act of 2001 provided for LLLPs.[147] The prefatory note to the Act of 2001 stated that in LLLPs, "no partner—whether general or limited—is liable on account of partner status for the limited partnership's obligations. Both general and limited partners benefit from a full, status-based liability shield that is equivalent to the shield enjoyed by corporate shareholders, LLC members, and partners in an LLP."[148] Essentially, an LLLP is merely a limited partnership with an additional limited-liability shield affixed. Currently, twenty-five states and the District of Columbia have enacted some form of an LLLP statute.[149]

2. Lack of a Nonparticipation Requirement, but Limited Liability

The typical limited partnership structure does not shield a general partner from liability. If, however, the limited partnership registers as an LLLP under the applicable state statute, its general partner will effectively have limited liability.[150] Nevertheless, a more interesting aspect of the LLLP is how the application of the limited-liability shield

---

145. BISHOP & KLEINBERGER, *supra* note 8, ¶ 15.01[4] ("A limited liability limited partnership may be expressly authorized by the LLP law, expressly prohibited by the LLP law, or indirectly permitted by limited partnership law, which provides that general partnership law (including LLP registrations) governs in any case not provided for in limited partnership law." (footnote omitted) (citing REV. UNIF. LTD. P'SHIP ACT § 1105 (1976))).

146. *Id.*

147. UNIF. LTD. P'SHIP ACT prefatory note (2001) ("[T]he Act makes LLLP status available through a simple statement in the certificate of limited partnership."). *See also id.* § 102(9) ("'Limited liability limited partnership,' except in the phrase 'foreign limited liability limited partnership,' means a limited partnership whose certificate of limited partnership states that the limited partnership is a limited liability limited partnership.").

148. *Id.* prefatory note. *See also* REV. UNIF. P'SHIP ACT § 101 cmt. (1996) (providing for a limited partnership to form as an LLLP and suggesting limiting the liability for both general and limited partners).

149. BROMBERG & RIBSTEIN, *supra* note 104, Table 5-1, at 205–06 (providing that the following states recognize LLLPs: Alabama, Arizona, Arkansas, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Kentucky, Maine, Maryland, Missouri, Nevada, New Mexico, North Carolina, North Dakota, Pennsylvania, South Dakota, Tennessee, Texas, Virginia, and Washington, as well as the District of Columbia).

150. *See id.* § 5.02(a), at 201 (stating that "general partners in an LLLP are liable to the same extent as general partners in an LLP" and that "general partners [in LLLPs] may be able to waive the liability limitation").

to limited partners varies based on the various state laws.[151] Commonly, the LLLP status allows limited partners "to participate in the business without the risk of becoming personally liable for partnership obligations."[152] Limited partners are afforded such protection "only if they otherwise become liable for partnership obligations under limited partnership law (as opposed to other methods, such as a personal guaranty)."[153] Accordingly, the application of this additional liability shield to limited partners effectively eliminates the nonparticipation requirement imposed on limited partners.[154] Alternatively, a small number of states have permitted limited partnerships to become an LLLP, without expanding the traditional limited partnership rules with respect to limited partners.[155] These states effectively maintain the nonparticipation requirement. In those states that have adopted the Act of 2001, however, there is no need to extend the additional protection to limited partners, as the Act of 2001 provides for limited liability of limited partners regardless of their level of participation.[156]

Regardless of a general partner's level of participation in an LLLP, the general partner maintains his limited-liability shield. Whether a limited partner retains his limited-liability shield regardless of his level of participation, however, depends on the law of the state in which the LLLP is registered.

---

151. *See id.* Table 5-1, at 205–06 (showing a variety of effects different limited liability shields may have depending on the state of enactment).

152. BISHOP & KLEINBERGER, *supra* note 8, ¶ 15.01[1].

153. *Id.* ¶ 15.01[4].

154. BROMBERG & RIBSTEIN, *supra* note 104, § 5.02(b), at 201 ("The main effect of applying the LLP liability limitation to limited partners is to reduce the effect of the 'control rule . . . .'").

155. *See id.* Table 5-1, at 205–06 (providing that of the states that recognize LLLPs, Georgia, Missouri, North Carolina, Pennsylvania, and Tennessee do not extend the additional liability shield to limited partners).

156. *See supra* Part III.A.2.c (discussing the Act of 2001); *see also* UNIF. LTD. P'SHIP ACT § 104 cmt. (2001) ("Acquiring or relinquishing an LLLP shield changes only the rules governing a general partner's liability for subsequently incurred obligations of the limited partnership. The underlying entity is unaffected."); *id.* § 104(a) ("A limited partnership is an entity distinct from its partners. A limited partnership is the same entity regardless of whether its certificate states that the limited partnership is a limited liability limited partnership."); BROMBERG & RIBSTEIN, *supra* note 104, Table 5-1, at 205–06 (providing that of the states that recognize LLLPs, Alabama, Arkansas, Hawaii, Idaho, Illinois, Iowa, Kentucky, Maine, Nevada, New Mexico and North Dakota have adopted ULPA of 2001).

IV. WHAT IS A LIMITED PARTNER FOR THE PURPOSE OF § 469(H)(2) OF THE CODE?

In light of the evolution of the limited partnership and the development of limited liability entities, how does § 469(h)(2) of the Code apply in today's business environment? In order to answer this question, one must determine the meaning of "limited partner" for the purposes of § 469(h)(2) of the Code. Such a determination is best achieved by examining the viewpoint of each governmental branch of the term "limited partner" in the context of § 469 of the Code.

A. The Congressional View of the Term "Limited Partner"

With the enactment of § 469 of the Code, Congress intended to allow only those taxpayers who had "substantial and *bona fide* involvement in [an] activit[y]" to reap the tax benefit of using losses and deductions created by the activity to offset income from other activities.[157] Congress determined that this objective could "best be accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax-shelter benefits."[158] The Senate Finance Committee noted that § 469 of the Code focused on participation in an activity and did not consider whether a taxpayer is liable for an activity.[159] Specifically, the Committee stated that:

> The distinction that the committee believes should be drawn between activities on the basis of material participation bears no relationship to the question of whether, and to what extent, the taxpayer is at risk with respect to the activities. In general, the fact that a taxpayer has placed a particular amount at risk in an activity does not establish, prior to a disposition of the taxpayer's interest, that the amount invested, or any amount, has as yet been lost. The fact that a taxpayer is potentially liable with respect to future expenses or losses of the activity likewise has no bearing on the question whether any amount has as yet been lost, or otherwise is an appropriate current deduction or credit.[160]

157. S. REP. NO. 99-313, at 716 (1985).

158. *Id.* at 717.

159. *Id.*

160. *Id.* (footnote omitted). "At-risk standards, although important in determining the maximum amount that is subject to being lost, are not a sufficient basis for determining whether or when net losses from an activity should be deductible against other sources of income, or for determining whether an ultimate economic loss has been realized." *Id.*

In certain instances, however, Congress intended that "financial risk or other factors, rather than material participation, should be the relevant standard."[161] For example, in the oil and gas industry, Congress thought it necessary to attract outside investors with tax benefits specifically limited "to investors who are willing to accept an unlimited and unprotected financial risk proportionate to their ownership interests in the oil and gas activities."[162] Clearly, Congress intended to provide a benefit only to oil and gas investors who accepted unlimited financial risk.[163] As a result, Congress promulgated § 469(c)(3)(A) of the Code,

---

161. *Id.* While outside the scope of this paper, the Committee additionally stated that:

> A further area in which the material participation standard is not wholly adequate is that of rental activities. . . . Rental activities generally require less on-going management activity, in proportion to capital invested, than business activities involving the production or sale of goods and services. Thus, for example, an individual who is employed full-time as a professional could more easily provide all necessary management in his spare time with respect to a rental activity than he could with respect to another type of business activity involving the same capital investment. The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.
>
> A limited measure of relief, however, is believed appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are designed to provide financial security, rather than to shelter a substantial amount of other income.

Id. at 718. Accordingly, Congress promulgated § 469(c)(2) of the Code, which provided that rental activities were per se passive. Additionally, Congress promulgated an exception to § 469(c)(2) of the Code, which provided for a limited deduction with respect to rental activities if the taxpayer "actively participated." I.R.C. § 469(i). Similar to § 469(h)(2) of the Code, Congress provided that a limited partner could not actively participate. *Id.* § 469(i)(6)(C) ("Except as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates."). The Treasury Regulations define "limited partnership interest" for the purposes of § 469(i)(6)(C) of the Code by reference to the Treasury Regulation definition of "limited partnership interest." Treas. Reg. § 1.469-9(f)(1). Thus, if a member or partner of a limited liability entity is considered a limited partner, the member or partner is prevented from qualifying under the "active participation" exception for rental real estate activity. For the same reasons stated in this Article calling for the repeal of § 469(h)(2) of the Code, Congress should also repeal § 469(i)(6)(C) of the Code.

162. *Id.* at 717–18. The Committee recognized that the oil and gas industry was "suffering severe hardship due to the worldwide collapse of oil prices." *Id.* at 717. Thus, it "believe[d] that relief for this industry require[d] that tax benefits be provided to attract outside investors." *Id.*

163. *Id.* at 718.

> Granting tax shelter benefits to investors in oil and gas activities who did not accept unlimited risk, proportionate to their ownership investments in the activities, would permit the benefit of this special exception to be diverted unduly to the investors, while providing less benefit to oil and gas activities and threatening the integrity of the entire rule limiting the use of nonparticipatory business losses.

Id.

which provided that "[t]he term 'passive activity' shall not include any working interest in any oil or gas property which the taxpayer *holds directly or through an entity which does not limit the liability of the taxpayer* with respect to such interest."[164] Congress could have simply decided that the term "passive activity" shall not include any working interest in any oil or gas property that the taxpayer holds directly or through an "interest in a limited partnership as a limited partner."[165] In drafting § 469(c)(3)(A) of the Code, however, Congress broadened the application of § 469(c)(3)(A) of the Code beyond just limited partnerships by applying it to any other entity that could "limit the liability of the taxpayer."[166] Accordingly, § 469(c)(3)(A) of the Code focused on limited liability, and Congress drafted language broad enough to encompass any future entities that provide a limited-liability shield to a taxpayer. When Congress intended for § 469 of the Code to apply based on the taxpayer's limited-liability shield with respect to an activity, it used specific, yet expansive, language.

Yet, in § 469(h)(2) of the Code, Congress did not use language similar to that in § 469(c)(3)(A) of the Code. Rather, Congress focused only on limited partners in a limited partnership and stated that "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."[167] If Congress had intended to focus the per se passive-activity rule in § 469(h)(2) of the Code on the fact that limited partners have a limited-liability shield, Congress could have drafted § 469(h)(2) of the Code to be similar to § 469(c)(3)(A) of the Code. For example, Congress could have drafted § 469(h)(2) of the Code to read as follows: Except as provided in regulations, no interest *held directly or through a partnership which limits the liability of the taxpayer* shall be treated as an interest with respect to which a taxpayer materially participates. Congress did not draft § 469(h)(2) of the Code this way because the per se rule of § 469(h)(2) of the Code was not based on limited liability, but rather on the limited partner's participation.

Instead, Congress specifically looked at the application of § 469 of the Code as it pertained to limited partnerships, which were the most

164. I.R.C. § 469(c)(3)(A) (emphasis added). *See* Temp. Treas. Reg. § 1.469-1T(e)(4)(v) (describing the types of entities that limit liability).

165. I.R.C. § 469(h)(2) (using the term "interest in a limited partnership as a limited partner" in determining if the per se passive-activity rule applies).

166. *See* Temp. Treas. Reg. § 1.469-1T(e)(4)(B).

167. I.R.C. § 469(h)(2).

common choice for those participating in a tax shelter.[168] After examining the limited partnership, Congress promulgated § 469(h)(2) of the Code based on the notion that limited partners could not participate in the partnership's business activity.[169] Accordingly, Congress enacted the per se rule of § 469(h)(2) of the Code based on administrative convenience. When drafting the special rule of § 469(h)(2) of the Code, the Senate commented that:

> The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership. Moreover, since a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status, the committee believes it *should not be necessary* to examine general facts and circumstances regarding material participation in this context. Therefore, under the bill, a limited partnership interest is treated as intrinsically passive (except as provided in regulations).[170]

Since the purpose of being a limited partner—obtaining limited-liability protection—would be defeated by material participation in the business activity of the partnership, Congress thought it unnecessary to evaluate whether a limited partner materially participated. Therefore, while the use of tax shelters was a target of the Tax Reform Act of 1986,[171] § 469 of the Code focused on a limited partner's inability to participate while still maintaining his limited-liability shield.[172]

---

168. S. REP. NO. 99-313, at 720.

169. *Id.* at 718 ("In order to maintain limited liability status, a limited partner generally is precluded from materially participating in the business activity of the partnership; in virtually all respects, a limited partner more closely resembles a shareholder in a C corporation than an active business entrepreneur.").

170. *Id.* at 720 (emphasis added). *See also id.* at 734 n.20 (referencing § 464 of the Code that disallows certain "prepaid expenses incurred in a farming activity" for "limited partners or persons who do not actively participate in management").

171. STAFF OF THE J. COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 6 (Joint Comm. Print 1987) (providing that the purpose of the 1986 Act was to "assure a fairer, more efficient, and simpler tax system," which could regain the trust of the American people). The report went on to discuss how simplicity would decrease the tax shelter industry, as "[t]he complexity [faced] by other taxpayers . . . helped spawn a thriving tax shelter industry which sought to reduce tax liability by making use of special tax provisions and by engaging in sophisticated financial arrangements." *Id.* at 11. Furthermore, with regard to fairness, "other individuals, unable to take advantage of tax shelters, had lost confidence in the tax system and may have responded by evading their tax liability." *Id.* at 7. The Committee has adopted a significant new provision which directly restricts the use of tax shelter losses to offset unrelated income. *Id.*

172. *See supra* notes 99–104 and accompanying text (discussing how the Act of 1985 allowed limited partners to substantially participate in the partnership without forfeiting their limited-liability shield). In 1986, Congress's perception that if a limited partner participated he would lose his

Nevertheless, Congress granted the Treasury the authority to decide when a limited partner interest would not be deemed passive, thereby resulting in Treasury Regulation § 1.469-5T(e).[173]

B. The Administrative View of the Term "Limited Partner"

In 1988, prior to the mainstream acceptance and use of LLCs and the creation of LLPs and LLLPs, Treasury Regulation § 1.469-5T(e) defined, for the purposes of § 469 of the Code, the term "limited partnership interest."[174] The Treasury, however, did not define the term "limited partner" or distinguish between a limited partner and a general partner.[175] Treasury Regulation § 1.469-5T(e) simply provided that a partnership interest shall be treated "as a limited partnership interest" if it meets one of two standards.[176] The first standard provides that a partnership interest is a limited partnership interest if "[s]uch interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law."[177] Essentially, such a standard simply requires that the taxpayer be called a "limited partner" in either the limited partnership agreement or the certificate of limited partnership. This designation is purely procedural and has nothing to do with whether the taxpayer's liability is limited under state law.

On the other hand, the second standard relies strictly on limited liability under state law and provides that a partnership interest is a limited parnership interest if:

---

limited liability shield was misplaced. At the time of promulgating § 469(h)(2) of the Code, however, the Act of 1985 was not widely adopted by states. Additionally, § 469 of the Code was in its infancy in mid-1985. *See also* Banoff & Lipton, *supra* note 9, at 205 ("The Senate committee also assumed—*wrongly*—that income allocable to a limited partner automatically was passive due to the nature of limited partnerships and the inability of limited partners to participate actively in an activity if they wish to maintain limited liability status." (emphasis added)).

173. I.R.C. § 469(h)(2) (2006). *See also* S. REP. NO. 99-313, at 731 ("Under the bill, the Secretary of the Treasury is empowered to-[sic] provide through regulations that limited partnership interests in certain circumstances will not be treated (other than through the application of the general facts and circumstances test regarding material participation) as interests in passive activities.").

174. Temp. Treas. Reg. § 1.469-5T(e)(3)(i)(A)–(B) (2011).

175. *See id.*

176. *Id.*

177. *Id.* § 1.469-5T(e)(3)(i)(A).

> 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 (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).[178]

A literal reading of the regulation would suggest that any partner or member whose liability is limited under state law would have a limited partnership interest, even if the entity were not a limited partnership under state law.[179] In providing that a limited partner, for the purposes of § 469(h)(2) of the Code, is any taxpayer whose interest in a partnership provides a limited-liability shield, Treasury Regulation § 1.469-5T(e) expanded § 469(h)(2) of the Code beyond its legislative purpose.[180]

When the IRS promulgated Treasury Regulation § 1.469-5T(e), it also defined "an entity that limits . . . liability" for purposes of the oil and gas provision of § 469(c)(3)(A) of the Code.[181] As discussed above, the application of § 469(c)(3)(A) of the Code turns on whether a taxpayer holds an interest in oil and gas property through "an entity which does not limit the liability of the taxpayer."[182] On the other hand, the application of § 469(h)(2) of the Code depends on whether a taxpayer holds an "interest in a limited partnership as a limited partner."[183] In Treasury Regulation §§ 1.469-5T(e) and 1.469-1T(e), however, the IRS adopted substantially the same definitions for the phrases "limited partnership interest"[184] and "[e]ntit[y] that limit[s] liability."[185] Under Treasury Regulation § 1.469-1T(e) an "[e]ntit[y] that limit[s] liability" includes:

> (1) A limited partnership interest in a partnership in which the taxpayer is not a general partner;
>
> (2) Stock in a corporation; or

178. *Id.* § 1.469-5T(e)(3)(i)(B).

179. *But see infra* Part IV.C.2 (discussing the plain-meaning approach used by the court in *Thompson*).

180. *See supra* Part IV.A.

181. T.D. 8175, 1988-1 C.B. 191.

182. *See* I.R.C. § 469(c)(3)(A) (2006); *see also supra* note 163 and accompanying text.

183. I.R.C. § 469(h)(2); *see also supra* note 164 and accompanying text.

184. *See* Treas. Reg. § 1.469-5T(e)(3) (2011).

185. *See id.* § 1.469-1T(e)(4)(v).

> (3) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).[186]

While Congress specifically limited the application of § 469(h)(2) of the Code to an "interest in a limited partnership as a limited partner," Treasury Regulation § 1.469-5T(e), in the context of partnerships, expanded the definition to encompass the same entities described in Treasury Regulation § 1.469-1T(e).[187] Clearly, if Congress had intended for the application of § 469(h)(2) of the Code to apply as broadly as the application of § 469(c)(3)(A) of the Code, Congress would have used the term "an entity that limits liability" in § 469(h)(2) of the Code, instead of the term "interest in a limited partnership as a limited partner."[188] The IRS undoubtedly cannot circumvent congressional intent by the mere stroke of a pen. Thus, while outside the scope of this Article, Treasury Regulation § 1.469-5T(e) is arguably invalid, as it expands the application of § 469(h)(2) of the Code outside the intent of Congress.[189]

Despite this clear expansion, the IRS took the position that § 469(h)(2) of the Code not only applied to limited partnerships, but also to limited liability entities. Following the *Thompson* and *Garnett* decisions holding that neither a member in an LLC nor a partner in an

186. *Id.*

187. *Id.*

> In addition, a partnership in which a taxpayer is a general partner is treated as an entity that does not limit the taxpayer's liability, and any working interest that the taxpayer holds through such a partnership is treated as an interest in an activity that is not a passive activity. Thus, deductions from the working interest (including deductions allocable to a limited partnership interest of the taxpayer) will not be subject to the passive loss limitation.

Income Tax, Limitations on Passive Activity Loss and Credits, 53 Fed. Reg. 5686, 5687 (Feb. 25, 1988) (to be codified at 26 C.F.R. pt. 1). Grace, *supra* note 71, at J-1 (providing a perspective on why the definition of an "interest in a limited partnership as a limited partner" under § 469(h)(2) of the Code was expanded to include entities with limited liability under state law).

188. *See supra* Part IV.A.

189. *But see* Thompson v. United States, 87 Fed. Cl. 728, 734 n.7 (2009).

> [The IRS] argues that this court owes substantial deference to an agency regulation promulgated in accordance with an express congressional mandate and to an agency's reasonable interpretation of such a regulation. However, [the taxpayer] agrees that the regulation is valid, and [the IRS] has not set forth, nor is this court aware of, any official IRS interpretation extending § 1.469-5T(e)(3) to include membership interests in LLCs. Therefore, this court owes no deference to [the IRS's] proffered interpretation, and the court may proceed unhindered in applying the appropriate canons of construction.

Id. (citations omitted).

LLP is a limited partner for purposes of § 469 of the Code, the IRS issued a notice agreeing that "LLC interests are not 'limited partnership interests.'"[190] In this notice, the IRS made no mention as to its position with respect to an LLP. In December 2010, the IRS commented that it would soon issue guidance in this area; however, no guidance yet exists.[191] Accordingly, it is still unclear if the IRS's position remains that, for the purpose of § 469(h)(2) of the Code, a partner in an LLP or LLLP is considered a limited partner.

C. The Judicial View of the Term "Limited Partner"

In the summer of 2009, within twenty days of each other, *Thompson* and *Garnett* addressed the meaning of the term "limited partner" for purposes of § 469(h)(2) of the Code.[192] While both courts held that an LLC is not subject to the per se passive-activity rule of § 469(h)(2) of the Code, each court based its decision on different lines of reasoning.

The United States Tax Court held in *Garnett* that an LLC member qualified under the general-partner exception.[193] The court also held that an LLP partner was not subject to the per se passive-activity rule of § 469(h)(2) of the Code because an LLP qualifies under the general-partner exception.[194]

Conversely, the United States Court of Federal Claims, analyzing the statute's plain meaning, held in *Thompson* that an LLC member was not a limited partner under the definition provided for in Treasury Regulation § 1.469-5T(e) because an LLC is not formed as a partnership under state law.[195]

---

190. Thompson v. United States, 87 Fed. Cl. 728 (2009), *action on dec.*, 2010-02 (May 21, 2010).

191. *See* DEP'T OF THE TREASURY, 2010–2011 PRIORITY GUIDANCE PLAN, *supra* note 16, at 19.

192. *See generally Thompson*, 87 Fed. Cl. at 732–35; Garnett v. Comm'r, 132 T.C. 369, 374–80 (2009).

193. *Garnett*, 132 T.C. at 381. The Tax Court held that an LLC member and a partner in an LLP qualified under the general-partner exception to § 469(h)(2) of the Code. *Id.* Thus, the taxpayer was entitled to use all seven material-participation factors in determining if the taxpayer's activities were passive or not.

194. *Id.*

195. *Thompson*, 87 Fed. Cl. at 734.

1. The General-Partner-Exception Approach

In *Garnett*, the United States Tax Court held that the general-partner exception of Treasury Regulation § 1.469-5T(e) applied to both LLC members and LLP partners.[196] Thus, LLC members and LLP partners are not subject to the per se rule of § 469(h)(2) of the Code. The court succinctly stated the rationale for its ruling:

> The need to pigeonhole the ownership interests as either general partner interests or limited partner interests arises in the first instance from the fiction of treating an L.L.P. or an L.L.C. as a "limited partnership" under section 1.469-5T(e)(3)(i). Inasmuch as classifying an L.L.P. or L.L.C. interest as a limited partnership interest entails a departure from conventional concepts of limited partnerships, it similarly entails, we believe, a departure from conventional concepts of general partners and limited partners.[197]

The court began its analysis by stating that it was clear that Congress did not have an LLC or an LLP in mind when promulgating § 469(h)(2) of the Code.[198] Furthermore, as the court observed, the temporary regulations make no mention of LLCs or LLPs.[199] Nevertheless, the court felt compelled to determine whether § 469(h)(2) of the Code applied to either an LLC or an LLP. To make this determination, the court ultimately looked to the differences between limited partnerships, LLCs, and LLPs.[200] The court then provided that "the operative condition for applying section 469(h)(2) of the Code is not simply that there be an 'interest in a limited partnership' but an 'interest in a limited partnership *as a limited partner*.'"[201] Thus, there are two requirements:

---

196. *Garnett*, 132 T.C. at 381 (2009). *See Thompson*, 87 Fed. Cl. at 738 (adopting the *Garnett* court's general-partner exception as an alternative).

197. *Garnett*, 132 T.C. at 380–81 (internal citation omitted).

198. *Id.* at 374–75.

> We can be certain that when it enacted section 469(h)(2) in 1986, Congress did not have L.L.P.s specifically in mind, since L.L.P.s did not come into existence until 1991. Similarly, it is doubtful that Congress had L.L.C.s specifically in mind, since only one State, Wyoming, had an L.L.C. statute in 1986.

Id. (citations omitted).

199. *Id.* at 375 ("The temporary regulations, promulgated in 1988, make no explicit reference to L.L.P.s or L.L.C.s.").

200. *Id.* at 375–76. The court focused on the ability of the partner or member to participate and still maintain their limited liability shield. *Id.* at 375–76. Additionally, the court discussed how, for tax purposes, the limited partnership, LLC, and LLP were all treated as partnerships. *Id.* at 376 (citing I.R.C. § 761(a)).

201. *Id.* at 376–77.

(1) the entity must be a limited partnership; and (2) the taxpayer's interest must be that of a limited partner.[202]

The court spent very little time determining whether an LLC and an LLP were limited partnerships for the purpose of § 469(h)(2) of the Code. The court simply acknowledged that "[Treasury Regulation] section 1.469-5T(e)(3)(i) would appear to treat such an interest [in an LLC and LLP] as a 'limited partnership interest.'"[203] Consequently, the court turned to the question of whether the general-partner exception applied.[204]

Treasury Regulation § 1.469-5T(e)(3)(ii) outlines the general-partner exception by stating:

> A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).[205]

In the court's opinion, the general-partner exception clearly exists for those circumstances when a taxpayer holds both a limited interest and a general interest in a limited partnership.[206] Additionally, the exception as applied to a state law limited partnership would only be relevant when a general partner is also a limited partner because § 462(h)(2) of the Code would be inapplicable if the general partner did not hold a limited partner interest.[207] Taking things one step further, the court extended the

202. *Id.* (stating that the IRS's position that the taxpayers had a "limited partnership interest" merely because the taxpayers had limited liability in the entities under Treasury Regulation § 1.469-5T(e)(3)(i) overlooks the fact that § 469(h)(2) has two requirements).

203. *Id.* at 377–78 (citations omitted).

204. *Id.* at 378 ("If the general partner exception applies, however, then the ownership interest 'shall not be treated as a limited partnership interest.' The question, then, is whether the general partner exception applies." (citations omitted)).

205. Temp. Treas. Reg. § 1.469-5T(e)(3)(ii) (2011). *See supra* notes 69–71 and accompanying text (discussing the general-partner exception).

206. *Garnett*, 132 T.C. at 378 (citing Temp. Treas. Reg. § 1.469-5T(e)(3)(ii)).

207. *Id.* at 378 n.21.

> As a practical matter, it would not appear that the general-partner exception would be of much consequence as applied to a State law limited partnership in which the general partner does not also hold a limited partner interest. Because a general partner interest would appear unlikely to be characterized as a "limited partnership interest" under [§] 1.469-5T(e)(3)(i), the general partner exception would appear generally unnecessary if the general partner did not also possess a limited partner interest.

exception beyond taxpayers holding a dual interest.[208] Essentially, the court recognized that when applying the exception in the context of entities that only have one type of interest, such as an LLC or an LLP, the exception "takes on heightened significance."[209] Thus, the court examined the meaning of general partner for purposes of the general-partner exception and its application in the context of both an LLC member and an LLP partner.[210]

In exploring the meaning of the term "general partner," the court noted that neither Congress nor the IRS has defined "limited partner" for purposes of § 469(h)(2) of the Code.[211] In addition, as with the definition of a limited partner, neither institution has defined "general partner."[212] Thus, the court was tasked with determining both the meaning of the term "general partner" for purposes of § 469 of the Code and its application to both an LLC member and an LLP partner.

In making this determination, the court rejected the IRS's approach that the common usage of the term general partner means a taxpayer that has "'authority, actual or apparent, to act for and bind the copartnership.'"[213] The IRS suggested that the determination requires a factual inquiry into the "nature and extent" of an LLC member's and an LLP partner's authority to act on behalf of the entity.[214] The court declined to take this approach[215] because the court viewed it as:

Id. (citations omitted).

208. *Id.* at 378 (stating that "the general partner exception is not expressly confined" to situations "where a partner in a State law limited partnership possesses dual . . . interests").

209. *Id.* at 378 n.21.

> If we seek, however, to apply the temporary regulations to an entity like an L.L.P. or an L.L.C. which has a single type of ownership interest that does not correspond squarely to either a limited partner interest or a general partner interest but instead reflects aspects of each, the general partner exception takes on heightened significance.

Id.

210. *Id.* at 378–81.

211. *Id.* at 377. *See also id.* at 377 n.19 ("Certain proposed regulations define 'limited partner' '[s]olely for purposes of section 1402(a)(13)' and the regulations thereunder, dealing with self-employment tax. These proposed regulations do not expressly address the treatment of an L.L.P. or L.L.C. member." (citations omitted)).

212. *Id.* at 378 n.22 ("The term 'general partner' is used multiple times in the Code and the regulations but without a general definition. In certain contexts the term refers specifically to a 'general partner' in a limited partnership. More commonly, however, 'general partner' seems to refer more broadly to any partner (whether or not in a limited partnership) other than a limited partner." (citations omitted)).

213. *Id.* at 378–79.

214. *Id.* at 379.

215. *See id.* at 380. The court further found that:

> [M]embers of L.L.P.s and L.L.C.s . . . are not barred by State law from materially

> [C]losely akin to factual inquiries appropriately made under the general tests for material participation. To import them into the per se rule of section 469(h)(2) [of the Code] would tend, we believe, to blur that special rule and the general rules for material participation in a manner that is at odds with the statutory framework and legislative intent.[216]

By looking at the legislative history, the court determined that Congress treated a limited partner interest as presumptively passive because limited partnership law expressly limited a limited partner's ability to participate in the partnership.[217] The court then stated that "while limited liability was one characteristic of limited partners that Congress considered in the enactment of [§] 469(h)(2) [of the Code], it clearly was not, as [the IRS] suggests, the sole or even determinative consideration."[218] Instead, the court held that the statutory constraint on a limited partner's inability to participate was the reason for the per se rule of § 469(h)(2) of the Code, so further factual inquiry into whether a limited partner participated was unwarranted.[219] The court effectively defined "limited partner" for purposes of § 469(h)(2) of the Code as a

---

> participating in the entities' business. Accordingly, it cannot be presumed that they do not materially participate. Rather, it is necessary to examine the nature and extent of their participation. That factual inquiry is appropriately made . . . under section 469 [of the Code] and the regulations thereunder.

Id.

216. *Id.* at 379.

> [The parties do] not dispute that under Iowa law [petitioners] were not precluded from actively participating in the management and operations of the L.L.P.s and L.L.C.s. Nor does [the IRS] dispute that [the taxpayers] were given at least some role to play in the management of the L.L.P.s and L.L.C.s. [The IRS] contends, however, that these circumstances do not suffice to classify [the taxpayers] as general partners because: The partnership agreements here did not give [the taxpayers] the authority to take action on behalf of the partnerships as a general partner would (nor did [the taxpayers] function like they were general partners).

Id. (internal quotation marks omitted).

217. *Id.* "'[S]ince a limited partner generally is precluded from participating in the partnership's business if he is to retain his limited liability status, the committee believes it should not be necessary to examine general facts and circumstances regarding material participation in this context.'" *Id.* (quoting S. REP. NO. 99-313, at 720 (1985)). The court also observed that "[i]n general, under relevant State laws, a limited partnership interest is characterized by limited liability, and in order to maintain limited liability status, a limited partner, as such, cannot be active in the partnership's business." *Id.* at 380 (citing S. REP. NO. 99-313, at 731).

218. *Id.*

219. *Id.* ("[T]he more direct and germane consideration was the legislative belief that statutory constraints on a limited partner's ability to participate in the partnership's business justified a presumption that a limited partner generally does not materially participate and made further factual inquiry into the matter unnecessary.").

partner who lacked the ability to participate in the partnership.[220] Accordingly, a general partner is a partner who is not a limited partner.

In applying the participation standard to an LLC member or an LLP partner, the court held that holders of such interests are more akin to general partners because "unlike limited partners in State law limited partnerships, [LLC members and LLP partners] are not barred by State law from materially participating in the entities' business."[221] As a result, the court held that § 469(h)(2) of the Code was inapplicable to both an LLC member and an LLP partner under the general-partner exception. Yet, the court hinted that the IRS could amend the regulations, stating that "*absent explicit regulatory provision*, we conclude that the legislative purposes of the special rule of section 469(h)(2) [of the Code] are more nearly served by treating [LLP] and [LLC] members as general partners for this purpose."[222]

2. The Partners Plain-Meaning Approach

In *Thompson*, the United States Court of Federal Claims, in applying the plain-meaning approach, held that "[o]nce Treasury Regulation § 1.469-5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply

220. *Id.* at 375–76.

221. *Id.* at 380 (noting that LLC and LLP interests "differ[] significantly from the status of general partners in State law limited partnerships . . . [and] from that of limited partners in State law limited partnership). In response to the IRS's inconsistent filing position argument, the court resolved:

> [T]he Schedules K-1 that the companies issued to [the taxpayers] or the relevant holding L.L.C. described the interests as something other than that of a "general partner." In particular, the Schedules K-1 for the subject L.L.P.s . . . described each interest as that of a "limited partner"; the Schedules K-1 for the two L.L.C.s that were not holding L.L.C.s described each interest as that of a "limited liability company member." [The IRS] contends that [the taxpayers] obtained a tax benefit by failing to designate their interests as "general partner" interests, in that they thereby avoided self-employment tax pursuant to section 1402(a)(13), which excludes from self-employment earnings certain distributive shares of a "limited partner."
>
> . . . .
>
> In these circumstances, we are not persuaded that the alleged inconsistencies in the manner in which [the taxpayers'] interests were listed on the Schedules K-1 are material.

Id. at 382–83.

222. *Id.* at 381 (emphasis added) (citing Gregg v. United States, 186 F. Supp. 2d 1123 (D. Or. 2000)). However, the court refused to invalidate the regulation, stating that "[i]n reaching this result, we emphasize that we do not invalidate the temporary regulations in any respect but simply decline to fill any gap therein to reflect [the IRS's] litigating position in this case." *Id.*

inapplicable to a membership interest in an LLC."[223] "It makes little sense, therefore, to extend the Code's presumption concerning limited partners' lack of participation in their limited partnerships to [the taxpayer] and his LLC."[224] Accordingly, LLC members are not subject to the per se rule of § 469(h)(2) of the Code. The court was not persuaded by the IRS's position, which it made clear when it wrote that "[t]he nub of th[e] case [was] whether the government is collecting more taxes than written law and regulation allow."[225] The court continued:

> Perhaps demonstrating once again that "[l]ogic and taxation are not always the best of friends," the court rejects [the IRS's] position because, among other reasons, the tax code and the applicable regulations literally cannot be read to transfigure [the taxpayer's] member interest in his LLC into one of a limited partnership.[226]

The court began its analysis by stating that, "[a]s a threshold matter, it is important to note that an LLC is not a partnership."[227] The court then turned to the canons of statutory construction and examined the language of Treasury Regulation § 1.469-5T(e)(3),[228] which states, in part, that "a partnership interest shall be 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.*" [229] Ultimately, the court sought to "derive[] [the] plain meaning from its text, structure, and purpose."[230] The court held that, the regulation was unambiguous and the emphasized language

223. Thompson v. United States, 87 Fed. Cl. 728, 738 (2009) (citing *Gregg*, 186 F. Supp. at 1128).

224. *Id.* at 738.

225. *Id.* at 729.

226. *Id.* at 730 (citation omitted) (quoting Sonneborn Buns v. Cureton, 262 U.S. 506, 522 (1923) (McReynold, J., concurring)). The *Thompson* court settled the case on cross-motions for summary judgment. *Id.* Each party stipulated that if the LLC interest was subject to the per se rule of § 469(h)(2) of the Code, then the taxpayer could not prove material participation because fewer means existed by which the taxpayer could demonstrate his material participation. *Id.* If the LLC interest was deemed not to be subject to the per se rule of § 469(h)(2) of the Code, then the taxpayer could prove material participation. *Id.*

227. *Id.* at 733.

228. *Id.* at 733–34. The court expressly rejected the government's argument that deference should be given to Treasury Regulation § 1.469-5T(e)(3) because the government did not assert, and the court was not aware of, any formal guidance stating the regulation applied to an LLC. *Id.* at 734 n.7. Therefore, the court refused to give deference to a regulation that was the IRS's "'convenient litigating position.'" *Id.* (quoting Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 213 (1988)).

229. *Id.* at 734 (alteration in original) (citing Temp. Treas. Reg. § 469-5T(e)(3) (2011)).

230. *Id*. (citing Prati v. United States, 81 Fed. Cl. 422, 430 (2008)).

clearly required that the entity be a partnership for state law purposes.[231] The court also stated that whether an entity was a partnership for tax law purposes was irrelevant.[232] Furthermore, the court examined the language of § 469(h)(2) of the Code, as Treasury Regulation § 1.469-5T(e)(3) is the IRS's interpretation of § 469(h)(2) of the Code.[233] In agreement with *Garnett*, the *Thompson* court stated that not only was a limited partnership interest required, but also the interest must be that of a limited partner.[234] Thus, the court held that an LLC is not a limited partnership and an LLC member is not a limited partner.[235]

In examining what the term "limited partner" meant for purposes of § 469(h)(2) of the Code, the court, similar to the court in *Garnett*, determined that participation was the key difference between a limited partner and a general partner.[236] The court stated that limited liability is not the "dividing line" in determining if a partner is a limited partner or general partner[237] because, at the time Congress enacted § 469 of the Code, "there was general agreement among state laws that a limited partner would lose his limited liability status if he participated in the control of the business."[238] Thus, the court, as in *Garnett*, effectively

---

231. *Id.*

232. *Id.* at 733–35 (rejecting the IRS's argument "that it was nevertheless proper for the IRS to treat [an LLC interest] as a limited partnership interest under Treasury Regulation § 1.469-5T(e)(3)(i)(B) because [the taxpayer] elected to have [the LLC] taxed as a partnership for income tax purposes and because [the taxpayer's] liability [was] limited").

233. *Id.* at 734.

234. *Id*. *See also supra* note 202 and accompanying text (discussing the *Garnett* court's analysis of the two-prong test).

235. *Id*. *But see* Garnett v. Comm'r, 132 T.C. 368, 377 (2009) (rejecting the taxpayers' assertion that the definition of limited partner should be interpreted narrowly to include only an interest that is classified under state law as a limited partner in a limited partnership).

236. *Thompson*, 87 Fed. Cl. at 735 (agreeing with the taxpayer's contention "that the key feature or attribute differentiating the two interests is the ability to participate in the control of the business").

237. *Id.* at 736 (stating that "[i]f Congress desired a test that turned on a taxpayer's level of liability, it surely would have included the word 'liability' somewhere in the statute"). At oral argument, Judge Wolski stated that:

> "[I]n interpreting the statute, then, doesn't that seem to imply rather strongly that Congress didn't believe that it was the limit to liability alone that was the problem, but, in fact, it was the limit on material participation, which is what the whole statute was getting at, was material participation; otherwise, it could have addressed the S corp. as well. If you're the owner of an S corp., you're probably materially participating in what the S corp. does because you're the owner . . . ."

Consolidated Brief in Support of Plaintiff's Motion for Partial Summary Judgment at 17, Thompson v. United States, 87 Fed. Cl. 728 (2009) (No. 06-211T).

238. *Thompson*, 87 Fed. Cl. at 736 ("Stated another way, a limited partner's level of participation in the control of the business dictated whether or not he enjoyed limited liability.").

defined "limited partner," for purposes of § 469(h)(2) of the Code, as a partner who lacked the ability to participate in the partnership.[239] Accordingly, a general partner is a partner who is not a limited partner.

After reaching this conclusion, the court also found that even if an LLC were a limited partnership pursuant to Treasury Regulation § 1.469-5T(e)(3), the general-partner exception applied.[240] The court criticized the IRS for "ignor[ing] the . . . general partner exception . . . considering that the provision upon which [the IRS] bases its argument, § 1.469-5T(e)(3)(i), begins: 'Except as provided in [the general-partner exception] . . . .'"[241] Furthermore, the court called the IRS's position "self-serving"[242] because the IRS "twice conceded at oral argument that [the taxpayer] would be a general partner if [the LLC] were a limited partnership."[243] The IRS argued that "the legal fiction created by the Code—that an LLC electing partnership taxation is a limited partnership—does not extend to the [general-partner exception]."[244] The court concluded that the general-partner exception could apply because if an LLC member is deemed under Treasury Regulation § 1.469-5T(e)(3)(i) to have a limited partner interest in a limited partnership,

---

239. *Id.* at 738.

240. *Id.* at 734.

> And even if Treasury Regulation § 1.469-5T(e)(3) could apply to [an LLC member] and this court had to categorize [the LLC] membership interest as either a limited or a general partner's interest, it would best be categorized as a general partner's interest under § 1.469-5T(e)(3). At best, [the IRS] has identified an ambiguity in § 1.469-5T(e)(3) as it applies to LLCs. However, the court should decide such ambiguities in favor of the taxpayer.

Id. at 738 (citations omitted).

241. *Id.* at 734 (quoting Temp. Treas. Reg. § 1.469-5T(e)(3) (providing that the taxpayer's LLC interest "would not be a limited partnership interest under the regulations if [the taxpayer] could show that he were a general partner at all times during [the years at issue]")).

242. *Id.* at 735 ("Defendant ask[ed] th[e] court to equate [the taxpayer's] interest in [the LLC] to that of a limited partner's interest in a limited partnership under § 1.469-5T(e)(3)(i)(B), but also deny [the taxpayer] the possible benefit of § 1.469-5T(e)(3)(ii)'s general partner exception. . . . This position [struck] the court as entirely self-serving and inconsistent.").

243. *Id*. The IRS's position is apparent from the following exchange between Judge Wolski and IRS counsel:

> JUDGE WOLSKI: Again, limited partnerships are partnerships that have general partners. Who is the general partner in the LLC?
>
> DEF.'S COUNSEL: In the context of the '86 Act, [the taxpayer] would be the general partner.
>
> JUDGE WOLSKI: Well?
>
> DEF.'S COUNSEL: But he is not in a partnership. He is in an LLC, and under [§ 1.469-5T(e)(3)(i)(B)] . . . , he is required to be treated as a limited partner.

Id. at 735 n.8.

244. *Id.* at 735.

"then, alternatively, that same member could hold a general partner's interest under [the general-partner exception]."[245]

Yet, like in *Garnett*, the *Thompson* court hinted that the IRS could amend the regulations, stating that "'[i]n the absence of any regulation asserting that an LLC member should be treated as a limited partner of a limited partnership,'" the per se rule of § 469(h)(2) of the Code does not apply to an LLC.[246]

D. The Definition of Limited Partner

The application of § 469(h)(2) of the Code requires that: (1) the entity must be a limited partnership and (2) the taxpayer's interest must be that of a limited partner.[247] Thus, limited liability entities must first be considered a limited partnership in order for § 469 of the Code to apply. Treasury Regulation § 1.469-5T(e) defines a limited partnership interest for purposes of § 469 of the Code. If the *Thompson* approach is adopted, which requires that an entity be a partnership under state law,[248] an LLC would not be a limited partnership because an LLC is not formed as a partnership under state law.[249] Conversely, an LLP and an LLLP would be considered limited partnerships, for all intents and purposes, because both are formed under partnership law and both limit the liability of respective members or partners.[250] Alternatively, adopting the *Garnett* approach, which refused to narrowly construe the definition of limited partnership to only those entities formed as partnerships under state law,[251] would result in all limited liability entities being considered limited partnerships. Nevertheless, if Treasury Regulation § 1.469-5T(e) was held invalid for extending the definition of limited partnership contrary to legislative intent,[252] then only limited partnerships and LLLPs would be considered limited partnerships for two reasons—both are limited partnerships under state law and both have limited liability.[253]

245. *Id.*
246. *Id.* at 738 (quoting Gregg v. United States, 186 F. Supp. 2d 1123, 1129 (D. Or. 2000)).
247. *See supra* notes 202, 234 and accompanying text.
248. *See supra* note 231 and accompanying text.
249. *See* discussion *supra* Part III.B.
250. *See* discussion *supra* Parts III.C–D.
251. Garnett v. Comm'r, 132 T.C. 368, 377 (2009).
252. *See supra* notes 183–89 and accompanying text.
253. *See* discussion *supra* Parts III.A–D.

But the inquiry does not end there because § 469(h)(2) of the Code applies only to taxpayers who are also limited partners.

Based on the legislative history and the judicial interpretation of § 469(h)(2) of the Code, the definition of "limited partner" for purposes of § 469(h)(2) of the Code turns on whether state law allows the taxpayer to participate in the limited partnership.[254] As discussed above, a taxpayer who is prohibited from participating in the limited partnership will be deemed, as an administrative convenience, not to materially participate in the activity, unless the taxpayer can meet one of the three regulatory exceptions.[255] Under the participation definition, an LLC member[256] and all LLP partners, including the general partner, would not be limited partners because, under state law, they can all participate in their respective entity.[257] Additionally, neither a limited partner in a limited partnership nor a limited partner in an LLLP formed in a state that has adopted the Act of 2001[258] would be a limited partner for purposes of § 469(h)(2) of the Code because the Act of 2001 eliminated

254. *See* discussion *supra* Part IV.A–C. The Joint Committee on Taxation stated that the reference to limited partner in § 469(h)(2) of the Code "relates to the taxpayer's level of personal involvement in the activity of the entity." STAFF OF THE JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 285 (Joint Comm. Print 2001). Thus, the study recommended that the phrase "interests as a limited partner in a limited partnership" should be replaced by "a reference to a person whose participation in the management or business activity of the entity is limited under applicable State law." *Id. Compare id.* at 280 (calling for the modernization of references to "limited partner" in the tax code on a section-by-section basis), *with* Steven G. Frost & Sheldon I. Banoff, *Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs*, 100 J. TAX'N 326, 326, 344–45 (2004) (suggesting a uniform overall approach to defining the term "limited partner," but recognizing that the IRS has adopted a section-by-section approach). This Article uses a section-by-section approach because it is important to look at each section in which the term "limited partner" is used to determine what aspect of a limited partner Congress was focusing on when it promulgated the relevant section of the Code.

255. *See* discussion *supra* Part II.B.4.

256. *See Garnett*, 132 T.C. at 380 (providing, arguably, that the distinction between a manager-managed LLC and a member-managed LLC is irrelevant in determining if a member is a limited partner for purposes of § 469(h)(2) of the Code). *See also* Letter from Peter L. Faber on behalf of members of the Subcomm. on Limited Liability Cos. of the Comm. on P'ships of the ABA Section of Taxation, to Hon. Shirley D. Peterson, Comm'r, Internal Revenue Serv. (Mar. 12, 1992) (on file with author) (suggesting that it was inappropriate to apply the limited partnership tests to LLCs "because LLCs are designed to permit active involvement by LLC members in the management of the business and any assumption that LLC members are likely to be merely passive investors would be incorrect"). *See also supra* Part III.B.

257. *See* discussion *supra* Part III.C.

258. *See supra* note 110 and accompanying text (discussing those states that have adopted the Act of 2001).

the nonparticipation requirement.[259] Furthermore, a limited partner in an LLLP formed in a state in which the limited-liability shield extends to limited partners even if the limited partner participates in the LLLP would not be a limited partner for purposes of § 469(h)(2) of the Code because these states have effectively eliminated the nonparticipation requirement.[260]

The problem, however, arises when considering the level of participation required for participation under state law. In 1986, when Congress promulgated § 469(h)(2) of the Code, most of the states had not yet adopted the Act of 1985.[261] Congress based its reasoning for the per se rule of § 469(h)(2) of the Code on a limited partner's inability to substantially participate under the Act of 1976.[262] The Act of 1985, however, substantially weakened the nonparticipation requirement by extending the list of activities a limited partner could participate in without forfeiting his limited-liability shield and providing a "creditor reliance requirement."[263] Thus, the Act of 1985 allows a limited partner substantial latitude to participate in the limited partnership without losing his limited-liability shield. Consequently, in today's business environment, limited partners in a limited partnership formed under the Act of 1985 do not comport with the policy underlying the per se rule of § 469(h)(2) of the Code. Because all states have adopted either the Act of 1985 or the Act of 2001,[264] in some form, neither a partner in a limited partnership or a partner in an LLLP should qualify as a limited partner for purposes of § 469(h)(2) of the Code. The underlying purpose of § 469(h)(2) of the Code is lost in today's business environment. Instead, § 469(h)(2) of the Code only draws an artificial line between limited partnerships and limited liability entities—the latter of which allow partners or members to participate under state law without losing their limited-liability shield—and causes much unneeded confusion and litigation.

---

259. *See supra* Part III.A.2.c.

260. *See supra* notes 152–54 and accompanying text.

261. REV. UNIF. LTD. P'SHIP ACT prefatory note (1985) (providing that the Act was approved by National Conference of Commissioners on Uniform State Laws in August 1985).

262. *See supra* notes 94–98 and accompanying text (discussing provisions in the Act of 1976 relating to participation by limited partners).

263. *See supra* notes 101–04 and accompanying text.

264. *See supra* notes 110–11 and accompanying text.

V. CONCLUSION

In today's business environment § 469(h)(2) of the Code is outdated and outmoded. When Congress enacted § 469(h)(2) of the Code, it did so as a matter of administrative convenience and based its action on the principle that limited partners in a limited partnership could not participate in the activities of the limited partnership without foregoing their limited-liability shield. Both the Tax Court and the United States Court of Federal Claims agreed that participation was the focus of Congress, and each court effectively defined a "limited partner" as a partner who is not allowed to participate in the activity of an entity under state law for purposes of § 469(h)(2) of the Code. The IRS should not amend Treasury Regulation § 1.469-5T(e) to require that limited liability entities be subject to § 469(h)(2) of the Code. Instead, because today's business world has changed, Congress should repeal § 469(h)(2) of the Code and allow the Code to "keep pace with the times."