

Individuals and Passthrough Entities

By 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

Several provisions of the Code and regulations provide different rules that apply to the same transaction, depending on whether the taxpayer is a general partner or a limited partner. One of the most vexing tax issues facing members of limited liability partnerships (LLPs) and limited liability companies (LLCs) is whether a member of an LLC or an LLP is a general partner or a limited partner for purposes of many provisions of the Code. In *P.D. Garnett*,¹ the U.S. Tax Court held that owners of interests in LLCs and LLPs are general partners, and not limited partners, for purposes of determining whether they have materially participated in the LLC or LLP under the temporary Code Sec. 469 material participation regulations. In *J.R. Thompson*,² the U.S. Court of Federal Claims held that an LLC member was a general partner for the same purpose. *Garnett* and *Thompson* offer LLC and LLP members greater opportunities than are available to limited partners for establishing that they have materially participated in the business of the LLC or LLP.

Material participation is one of the most important requirements under the passive activity loss rules. Code Sec. 469 generally provides that a taxpayer may not deduct losses incurred in a passive activity to reduce income derived from non-passive activities (referred to as “active activities” or “active income”) or income from portfolio assets like stock, bonds and other financial instruments (referred to as “portfolio income”).³ Tax credits attributable to passive activities may not offset income tax liability on active or portfolio income.⁴ In most cases, a taxpayer who materially participates in an LLC’s or LLP’s business may use net



Susan Kalinka, J.D., is the Harriet S. Daggett-Frances Leggio Landry Professor of Law at the Paul M. Herbert Law Center of Louisiana State University in Baton Rouge.

losses derived from the entity's business to offset any type of income (active, passive or portfolio income) the taxpayer earns directly or through ownership of an interest in one or more passthrough entities. If a taxpayer materially participates in the business of an LLP or LLC, the taxpayer generally may use tax credits attributable to the entity's business to offset the member's tax liability on active, passive or portfolio income from any source.

Garnett and *Thompson* are not the first cases in which a court decided that an LLC member is a general partner for purposes of the passive activity loss rules. In 2000, the U.S. District Court for the District of Oregon decided *S.A. Gregg*,⁵ a case in which the court concluded that an LLC member was a general partner, and not a limited partner, for purposes of determining whether the LLC member materially participated in the LLC's business. The conclusion in *Gregg*, however, was only *dicta*. In *Gregg*, the court held that the LLC member was entitled to combine his participation in the LLC with his participation in another related business, thereby satisfying the requirements for material participation, regardless of whether the LLC member was classified as a limited partner or a general partner under the material participation regulations. The *Gregg* opinion only concerned whether Mr. Gregg, who was a member of an LLC, was to be treated as a general partner under the material participation regulations. Moreover, *Gregg* is of limited precedential value because it only applies to district courts in Oregon.

In contrast, the conclusions in *Garnett* and *Thompson* were material to the determination of the issue in those cases and were decided by the Tax Court, a court of national jurisdiction for tax deficiency cases, as well as the U.S. Court of Federal Claims, a court with national jurisdiction to decide tax refund cases. Moreover, *Garnett* treats members of both LLCs and LLPs as general partners under the regulations. The *Garnett* opinion also serves as precedent in every state unless and until it is overruled by Congress, a circuit court, or a later Tax Court opinion. *Thompson* also serves as precedent for taxpayers in any state unless and until it is overruled by Congress, the Federal Circuit, or another case decided by the Court of Federal Claims. This column will focus primarily upon the *Garnett* opinion because the *Thompson* court relied on it. Nevertheless, the *Thompson* court added reasons for reaching the conclusion that Congress intended members of entities like LLPs and LLCs to be treated as general partners for purposes of deter-

mining whether they have materially participated in the entity's business. This column will discuss the *Thompson* opinion whenever appropriate to facilitate the understanding of both courts' conclusions.

This column is Part I of a two-part series that discusses *Garnett* and *Thompson* and how they will be beneficial for LLP and LLC members seeking to deduct their distributive shares of LLP or LLC losses and claim their distributive shares of the entity's tax credits to reduce their tax liability on active and portfolio income. The *Garnett* and *Thompson* opinions, however, only address the status of an LLP or LLC member for purposes of determining whether the member has materially participated in the entity's business under the temporary Code Sec. 469 regulations. Part II, scheduled to appear in the November 2009 issue of TAXES—THE TAX MAGAZINE, will discuss the unresolved issues in *Garnett* and *Thompson*, suggest some solutions to those issues, and ask for more guidance.

Facts in *Garnett* and *Thompson*

The facts presented in *Garnett* are more extensive than the facts in *Thompson*. Thus, this column will spend more time discussing the facts in *Garnett* than the facts in *Thompson*.

In *Garnett*, Mr. and Mrs. Garnett owned interests in seven LLPs and two LLCs that were engaged in agribusiness operations, primarily the production of poultry, eggs and hogs.⁶ The Garnetts also owned interests in business ventures they characterized as tenancies in common. They owned most of the interests in those ventures indirectly through one or another of five separate LLCs ("the holding LLCs"). In addition, the Garnetts owned an interest in one LLP directly and interests in six other LLPs indirectly through one or another of the holding LLCs. All of the LLPs were registered with the state of Iowa. The LLPs reported income and expenses on Forms 1065. On Schedule K-1, each LLP identified Mr. Garnett as a "limited partner."

In general, the LLP agreements provided that each partner would participate actively in the control, management and direction of the partnership's business. Under the terms of the LLP agreements, no partner would be liable for the partnership's debts or obligations unless otherwise provided by Iowa law.

In addition to their interests in the holding LLCs, the Garnetts held a direct 16.66-percent interest in one LLC and an indirect 10.12-percent interest in another

LLC through one of the holding LLCs. Like the holding LLCs, those two LLCs were organized and operated under Iowa law. The LLCs reported their income and expenses on Forms 1065. On Schedule K-1, each LLC identified Mr. Garnett or the relevant holding LLC as a “limited liability company member.”

Under the terms of each of the two LLC operating agreements, the LLCs were exclusively manager-managed. The manager was to be elected by a majority vote of the LLC members and had the responsibility, *inter alia*, to “effectuate ... the regulations and decision of the Members.” The Garnetts were not managing members of the two LLCs that were not holding LLCs. The record indicated that Mr. Garnett was the manager of two of the holding LLCs but did not indicate who the manager was of the other three holding LLCs.

Mr. and Mrs. Garnett also owned indirect interests in two other business entities (GRD I and GRD II) through one of the holding LLCs. The Garnetts represented that GRD I and GRD II were “de facto” partnerships in Iowa, “holding title as tenants-in-common among three partners” (hereinafter referred to as the “tenancies in common”). The IRS did not dispute that characterization of GRD I and II. On their respective Forms 1065 for GRD I and II, the type of entity was listed as “TENANTS IN COMMON;” the principal business activity as “RENTAL REAL ESTATE.” On Schedule K-1, GFF I (one of the holding LLCs) is shown as holding a one-third share in each of GRD I and II; GFF I is identified as a “general partner” of GRD I and as a “limited partner” of GRD II.

On their joint income tax returns for the years in issue, the Garnetts reported income and losses from their interests in the LLCs, including the holding LLCs, and the LLPs. The IRS disallowed the losses on the ground that the Garnetts had failed to materially participate in the business of the entities generating net losses.

The plaintiff in *Thompson*, James R. Thompson, directly owned 99 percent of the member interests in Mountain Air Charter, LLC (“Mountain Air”), an LLC organized under the laws of Texas and classified as a partnership for federal tax purposes. Mr. Thompson owned the remaining one percent of the interests in Mountain Air through a Subchapter S corporation. Mr. Thompson was Mountain Air’s only manager. An IRS auditor had denied Mr. Thompson’s deduction of his share of Mountain Air’s losses claimed on Mr. Thompson’s 2002 and 2003 federal income tax returns. Mr. Thompson paid the deficiency and sued for a refund. In *Thompson*, the government

argued that Mr. Thompson was a limited partner in Mountain Air and that the deductions should be disallowed because they were passive losses.

Thompson was decided on summary judgment. Both parties agreed that if Mr. Thompson was a limited partner in Mountain Air during the tax years at issue, he did not materially participate in Thompson Air’s business within the meaning of the temporary Code Sec. 469 material participation regulations and the losses were properly disallowed. On the other hand, both parties also agreed that if Mr. Thompson was a general partner, he had materially participated in the LLC’s business during those years and the losses should have been allowed.

Passive Activity Losses— In General

Code Sec. 469 generally provides that a taxpayer may deduct a net loss incurred in a passive activity only to the extent that the taxpayer has net income from one or more other passive activities.⁷ Passive activity losses that are disallowed in any tax year are carried forward indefinitely and may be used to offset passive income earned in future years.⁸ Under Code Sec. 469, a taxpayer generally may use tax credits attributable to a passive activity (“passive activity credits”) only to the extent that the credits from all the taxpayer’s passive activities allowable for the tax year equal or exceed the taxpayer’s regular tax liability for the tax year allocable to all passive activities.⁹ Passive activity losses and credits that are disallowed for any tax year are carried forward indefinitely until the taxpayer has net income from passive activities or income tax liability allocable to passive activities in later years.¹⁰

The passive activity loss rules under Code Sec. 469 apply to any individual, estate or trust; any closely held corporation; and any personal service corporation.¹¹ If one of the persons to whom the passive activity loss rules apply owns an interest in a passthrough entity, like an S corporation or an entity classified as a partnership for federal tax purposes, the owner of the interest in the passthrough entity must determine whether its interest in the entity is an interest in a passive activity and, therefore, whether the taxpayer’s share of income or loss earned or incurred by the entity constitutes passive income or passive loss.

For this purpose, a passive activity includes any activity that involves the conduct of a trade or business in which the taxpayer does not materially

participate.¹² In general, a passive activity also includes any rental activity, regardless of whether the taxpayer materially participates in that rental activity.¹³ In contrast, the term “passive activity” does not include any working interest in oil or gas property that the taxpayer holds directly or through an entity that does not limit the taxpayer’s liability with respect to that interest, even if the taxpayer does not materially participate in the oil and gas activity.¹⁴

Because the LLPs and LLCs in *Garnett* were engaged in the active conduct of trades or businesses, the issue in that case concerned whether the Garnetts materially participated in businesses of the LLPs and LLCs during the years in issue. If the Garnetts materially participated in those businesses, their share of the entities’ losses would not be passive activity losses and could be used to offset their active and portfolio income.

Code Sec. 469 provides that a taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous and substantial.¹⁵ However, Code Sec. 469(h)(2) also 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.” Thus, if the Garnetts were considered limited partners for purposes of Code Sec. 469, they would be entitled to establish material participation in the activities of the LLCs and LLPs only to the extent allowed by regulations.

The issue of whether a general partner has materially participated in a partnership’s activities also is governed by regulations. Code Sec. 469 provides, in part:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations—

- (1) which specify what constitutes an activity, material participation, or active participation for purposes of this section,
- (2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income),
- (3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity, ...¹⁶

Temporary regulations have been issued that treat an individual taxpayer other than a limited partner as materially participating in an activity if the taxpayer meets one of the following seven tests:

- (1) The individual participates in the activity for more than 500 hours for the tax year.
- (2) The individual’s participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year.
- (3) The individual participates in the activity for more than 100 hours during the tax year, and such individual’s participation in the activity for such year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for the tax year.
- (4) The activity is a significant participation activity for the tax year, and the individual’s aggregate participation in all significant participation activities during such year exceeds 500 hours.
- (5) The individual materially participated in the activity for any five tax years during the 10 tax years that immediately precede the tax year.
- (6) The activity is a personal service activity, and the individual materially participated in the activity for any three tax years preceding the tax year.
- (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.¹⁷

For purposes of the fourth test, the temporary regulations define the term “significant participation activity” as a trade or business activity in which the individual participates for more than 100 hours during the tax year and in which the taxpayer otherwise would not be treated as materially participating.¹⁸ The temporary regulations also provide that a taxpayer will not be treated as materially participating in an activity under the seventh test (“the facts-and-circumstances test”) if the taxpayer participates in the activity for 100 or fewer hours during the tax year.¹⁹

It is more difficult for a limited partner to establish that he or she has materially participated in the business of a limited partnership. Under the temporary regulations, a limited partner owning a limited partnership interest is treated as materially participating in an activity only if the limited partner satisfies the first test (more than 500 hours), the fifth test (material participation in five out of the prior 10 tax years) or

the sixth test (material participation in a personal service activity for any three prior tax years).²⁰

For purposes of the material participation tests, the temporary regulations provide 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, to a determinable fixed amount. ...”²¹ Because the liability of individuals who hold interests in LLPs and LLCs is so limited, an LLP or LLC interest is a limited partnership interest within the meaning of the temporary Code Sec. 469 material participation regulations.

The General/Limited Partner Issue

The *Garnett* court concluded that the higher standard for material participation that applies to individuals who hold limited partnership interests does not apply to LLP or LLC members. The court observed that in 1986, when Congress enacted Code Sec. 469(h)(2), Congress did not have LLPs in mind because LLPs did not come into existence until 1991.²² The court also concluded that Congress did not have LLCs in mind when it enacted Code Sec. 469(h)(2) because there was only one state (Wyoming) that had enacted an LLC statute in 1986.²³ Moreover, the temporary Code Sec. 469 material participation regulations, promulgated in 1988, do not explicitly refer to LLPs or LLCs.²⁴ To determine whether Code Sec. 469(h)(2) applies to LLP or LLC members, the court reviewed the differences among LLPs, LLCs, and limited partnerships and the characteristics of limited partnerships that were important to Congress in drafting Code Sec. 469(h)(2).

The court described the three different forms of business organization as follows.²⁵ Limited partnerships have two types of partners, general and limited. General partners manage the partnership and are personally liable for all partnership debts and liabilities. In contrast, limited partners enjoy limited liability for partnership debts, as long as they do not participate in the control of the partnership. Limited partners generally are passive investors. A fundamental aspect of limited partnerships is that a limited partner may lose limited liability by taking part in the control of the partnership.

An LLP is a general partnership that files or registers with a state or state agency to obtain a form

of limited liability for its partners.²⁶ Other than shielding its partners from unlimited liability, an LLP generally is subject to the same provisions of the applicable state partnership statute.²⁷ Members of an LLP may and often do participate in the management and control of the LLP’s business without losing the limited liability shield offered by the LLP form of business organization.

An LLC is a hybrid of the corporate and partnership forms of business organization. Unlike corporate shareholders,²⁸ LLC members may directly participate in the control and day-to-day operation of the business.²⁹ Unlike limited partners, LLC members do not lose their limited liability for the LLC’s debts and obligations by taking part in such activities.³⁰

Notwithstanding the differences among the three forms of business organization, all of them qualify for classification as a partnership for federal tax purposes if they have two or more members.³¹ Under the check-the-box regulations, a domestic limited partnership, LLP or LLC is classified as a partnership if it has two or more members unless the business entity makes a check-the-box election to be classified as a corporation.³² Such entities are not required to make any election if they desire partnership classification.³³

Relying on the temporary Code Sec. 469 material participation regulations, the IRS argued that the distinctions among limited partnerships, LLPs and LLCs were irrelevant because all those forms of business organization offer limited liability to owners. The temporary Code Sec. 469 regulations specifically provide that a partnership interest “shall” be treated as a limited partnership interest if “[t]he liability of the holder of that interest for obligations is limited, under the law of the State in which the partnership is organized, to a 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).”³⁴ The IRS contended that the definition of the term “limited partnership interest” under the regulation ended the matter.

The court disagreed. The court noted that the operative condition for applying Code Sec. 469(h)(2) is not simply that there be an “interest in a limited partnership,” but also that the person holding the limited partnership interest must hold that interest “as a limited partner.” Thus, it was necessary to determine whether an LLP or LLC member holds his or her interest in the entity as a limited partner or as a general partner. The temporary Code Sec. 469

material participation regulations provide that a partnership interest of an individual “shall not be treated as a limited partnership interest for the individual’s tax year if the individual is a general partner in the partnership at all times during the partnership’s tax year ending with or within the individual’s partnership year (or the portion of the partnership’s tax year during which the individual (directly or indirectly) owns such limited partnership interest).” The Code and regulations, however, provide no definition of the term “general partner” or “limited partner” for purposes of Code Sec. 469.³⁵

The Garnetts suggested that the term “limited partner” should be interpreted literally to mean only a limited partner in an entity classified as a limited partnership under applicable state law. If the court had adopted such an interpretation, a member of an LLP or LLC never would be classified as a limited partner because neither an LLP nor an LLC is classified as a limited partnership under state law.

The court declined to accept the Garnetts’ suggestion. The court viewed the legislative history of Code Sec. 469(h)(2) as indicating that Congress intended the Treasury Department to have regulatory authority to treat “substantially equivalent entities” as limited partnerships.³⁶ As a corollary, the court opined that Congress also contemplated that at least some ownership interests in such “substantially equivalent entities” might be interests held as limited partners. The Senate Report provides, in part:

Under the bill, the Secretary of the Treasury is empowered to 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.

The exercise of such authority might also be appropriate where taxpayers sought to avoid limited partnership status with respect to substantially equivalent entities.³⁷

Instead, the court relied on the general partner exception under the temporary Code Sec. 469 regulations to determine that an LLP or LLC member is a general partner holding a limited partnership interest and thus qualifies for the exception. As explained above, the temporary regulations treat an individual’s partnership interest as other than a limited partnership

interest if the individual also is a general partner in the partnership.³⁸

As the caption of Temporary Reg. §1.469-5T(e)(3)(ii) (the general partner exception), “Limited partner holding general partnership interest,”³⁹ indicates, the general partner exception applies to situations where a partner in a limited partnership as characterized under state law owns dual limited and general partnership interests. The *Garnett* court observed, however, that by its terms, the general partner exception is not expressly confined to such a situation. The IRS did not dispute the court’s observation or argue that the general partner exception is categorically unavailable to LLP or LLC members. Instead, the court interpreted the IRS’s argument as suggesting that the application of the general partner exception depends on the extent of authority and control the LLP or LLC member enjoys.

The Code and the regulations provide no definition of the term “general partner.” The IRS contended that in common usage, a general partner is one who has actual or apparent authority to bind the partnership.⁴⁰

In contrast, the Garnetts maintained that they were general partners because Iowa law did not preclude them from actively participating in the management of the LLPs and LLCs in question. The IRS countered that the Garnetts were not general partners because the governing documents of the LLPs and LLCs did not give them the power to bind those entities. Accordingly, the IRS argued that the court should make threshold inquiries into the nature and extent of the Garnetts’ authority to act on behalf of the LLPs and the LLCs.

The court, in turn, determined that the threshold inquiries suggested by the IRS in *Garnett* seemed closely akin to the factual inquiries required under the general tests for material participation. To determine the proper inquiry in which it should engage, the court reviewed the legislative history of Code Sec. 469(h)(2) to determine the characteristics of a limited partner that concerned Congress in enacting a special rule for limited partners.

In setting forth “special considerations” that were relevant for treating limited partnership interests as presumptively passive under Code Sec. 469(h)(2), the legislative history provides, “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.”⁴¹

The legislative history also states, “in 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.”⁴² Thus, the *Garnett* court concluded:

[W]hile limited liability was one characteristic of limited partners that Congress considered in the enactment of section 469(h)(2), it clearly was not, as [the IRS] suggests, the sole or even determinative consideration. To the contrary, the 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.⁴³

The court believed that the rationale of the legislative history of Code Sec. 469(h)(2) properly extends to interests in LLPs and LLCs. Unlike limited partners, LLP and LLC members are not barred by state law from materially participating in the entity’s business. Thus, the court determined that it cannot be presumed that such members do not materially participate. Instead, the court concluded that it is necessary to examine the facts and circumstances to ascertain the nature and extent of the participation of an LLP or LLC member under Code Sec. 469 and the temporary Code Sec. 469 regulations’ seven tests for material participation that apply to general partners.

Accordingly, the court held that the Garnetts held their interests in the LLPs and LLCs as “general partners” within the meaning of the Code Sec. 469 regulations. The court noted that an LLP or LLC member’s status differs significantly from the status of a general partner, as well as the status of a limited partner in state law limited partnerships. The court also observed that the need to pigeonhole such ownership interests as either limited partnership interests or general partnership interests for purposes of the passive activity loss rules arises from the fiction of treating an LLP or an LLC interest as a limited partnership interest under the temporary Code Sec. 469 regulations. Because classifying an interest in an LLP or LLC as a limited partnership interest departs from conventional concepts of limited partnerships, the court believed that such a classification similarly entails a departure from conventional concepts of limited partners and

general partners. Absent an explicit regulatory provision, the court concluded that the legislative purpose of Code Sec. 469(h)(2) was best served by treating LLP and LLC members as general partners for purposes of determining whether such members have materially participated in the entity’s business.⁴⁴ Accordingly, the court held that the presumption under Code Sec. 469(h)(2) did not apply to the Garnetts’ interests in the LLPs and LLCs.

The *Thompson* court generally agreed with the analysis in *Garnett*. In *Thompson*, however, the Court of Federal Claims added other reasons for treating a member of an LLC as a general partner. The *Thompson* court noted that an LLC is not a limited partnership. Unlike an LLC whose members all enjoy limited liability and may freely participate in the management of the LLC without losing the limitation on their liability, a limited partnership must have two levels of partners: (1) limited partners, who have limited liability but are unable to participate in the management of the partnership; and (2) general partners, who may participate in the management of the partnership but are personally liable for its debts.⁴⁵

Moreover, the *Thompson* court determined that the statutory and regulatory framework of Code Sec. 469 does not support a dividing line between general and limited partnership interests based on limited liability, but rather a dividing line based on material participation in an activity. The court observed that the repeated references to the terms “activity,” “material participation” and “passive activity” throughout Code Sec. 469 and the regulations thereunder indicate that Congress was primarily concerned with the taxpayer’s level of involvement in the activity in question. The court opined that if Congress had desired to use a test that turned on a taxpayer’s level of liability, it “surely would have included the word ‘liability’ somewhere in the statute.”⁴⁶ The court also cited the following language from a report on tax shelters issued by the Joint Committee on Taxation in 1985 to support its conclusion that in enacting Code Sec. 469, Congress was more concerned with the taxpayer’s participation in a loss-generating activity, and not limited liability, as the government argued:

In general, a tax shelter is an investment in which a significant portion of the investor’s return is derived from the realization of tax savings with respect to other income, as well as the receipt of tax-favored (or potentially, tax-exempt) income from the in-

vestment itself. Generally, tax shelters are passive investments in the sense that the investor is not involved in actively managing a business.⁴⁷

The Joint Committee's report identifies the following three "elements of a tax shelter" none of which involve limited liability: (1) deferral of tax liability to future years, conversion of ordinary income to tax-favored income such as capital gains; and (3) leverage, *i.e.*, the use of borrowed funds to pay deductible expenditures.⁴⁸ The *Thompson* court also quoted the following language from the Joint Committee's General Explanation of the Tax Reform Act of 1986:

The distinction that Congress determined should be drawn between activities on the basis of material participation was viewed as unrelated to the question of whether, and to what extent, the taxpayer was at risk with respect to the activities.

At-risk standards, although important in determining the maximum amount that is subject to being lost, were viewed as 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. Congress concluded that its goal of making tax preferences available principally to active participants in substantial businesses, rather than to investors seeking to shelter unrelated income, was best accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax shelter benefits.⁴⁹

As the *Thompson* court noted, the quoted language indicates that in enacting a *per-se* rule, treating limited partners as nonmaterial participants (except as provided in regulations), Congress was more concerned that state law placed impediments on a limited partner's ability to participate in the management of a substantial business than on the limited partner's limited liability. Indeed, the *Thompson* court concluded that a member of an LLC is not a limited partner because an LLC is not "substantially equivalent" to a limited partnership within the meaning of the legislative history of Code Sec. 469.

Mr. Thompson, like Mr. Garnett in some cases, was a managing member of the LLC in which he was a member. The government admitted in *Thompson*

that if the entity in the case were a partnership, Mr. Thompson would have been a general partner. While Mr. Thompson's management authority, like Mr. Garnett's management authority, was significant, both courts adopted a *per-se* rule that a member of an LLC (or an LLP, in *Garnett*) is a general partner, and not a limited partner, for purposes of determining whether the member has materially participated in the entity's business under any of the seven tests set forth in temporary Code Sec. 469 material participation regulations.

The *Garnett* and *Thompson* opinions differ in one respect. The *Garnett* court invited the Treasury to issue regulations concerning the status of an LLP or LLC member as a general or limited partner for purposes of Code Sec. 469(h)(2). In contrast, the *Thompson* court was silent as to the Treasury's authority to issue such regulations. The *Thompson* court, however interpreted the legislative history of Code Sec. 469(h)(2) to mean that the Treasury only has the authority to issue regulations providing rules denying taxpayers limited partner status when such taxpayers seek to be classified as limited partners for tax sheltering purposes.⁵⁰ While Code Sec. 469 does not specifically authorize the Treasury to issue regulations treating LLP or LLC members to be treated as limited or general partners, the Treasury should have such authority under Code Sec. 7805. Code Sec. 7805(a) authorizes the Treasury to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code. Such authority should include the authority to provide definitions of the term "limited partner" and "general partner" for any purpose of the Code, including Code Sec. 469(h)(2).

***Garnett*: The Tenancies in Common**

In *Garnett*, the IRS did not dispute the Garnetts' characterization of GRD I and II as tenancies in common and did not expressly argue that those entities should be treated otherwise. Indeed, the IRS did not argue that an interest in a tenancy in common is a limited partnership interest within the meaning of the Code Sec. 469(h)(2) or the regulations thereunder, or that the Garnetts' liability with respect to their interests in the tenancies in common was limited within the meaning of the Code Sec. 469 regulations. Accordingly, the court concluded that the Garnetts' interests in GRD I and II were not interests in limited partnerships for purposes of Code Sec. 469(h)(2) and that

the Garnetts were not limited partners with respect to their interests in those entities.

Alleged Reporting Inconsistencies in *Garnett*

With one exception, the Schedules K-1 that the companies issued to the Garnetts or the relevant holding LLC described each of the interests as something other than the interest of a general partner. In fact, the Schedules K-1 for the LLPs and for one of the tenancies in common described each interest as that of a “limited partner.” The Schedules K-1 for the LLCs that were nonholding LLCs described each interest as that of a “limited liability company member.” The IRS argued that the Garnetts obtained a tax benefit by failing to designate their interests as “general partner” interests, because they avoided self-employment taxes under Code Sec. 1402(a)(13), which excludes from net self-employment earnings certain distributive shares of a “limited partner.”

The Garnetts maintained that they or the holding LLCs were listed as “limited partners” on the LLPs’ schedules K-1 only because Schedule K-1 does not list “limited liability partner” as one of the check-the-box options. The Garnetts, however, did not explain why one of Schedules K-1 identified one of the holding LLC’s interest as that of a “general partner,” while another Schedule K-1 described the interest of another holding LLC as that of a “limited partner.”

The court saw no inconsistency in the reporting of an LLC member’s interest as that of a “limited liability company member.” The IRS conceded that the manner in which the Schedules K-1 described the interests did not conclusively establish that the Garnetts held the interests as limited partners. Moreover, the IRS did not contend that the Garnetts were collaterally estopped or constrained by any duty of consistency from asserting in Tax Court that they did not hold their interests as limited partners for purposes of Code Sec. 469(h)(2). The notice of deficiency and the answer the IRS filed in Tax Court did not assert any deficiency attributable to an underpayment of self-employment taxes.

Under the circumstances, the court concluded that the alleged inconsistencies in the manner in which the Schedules K-1 described the Garnetts’ interests was not material. Furthermore, the IRS did not set forth specific facts to show that there was a genuine issue of material fact to preclude the court from issuing summary judgment on the issue of the

application of Code Sec. 469(h)(2) to the Garnetts.⁵¹ Accordingly, the court granted the Garnetts’ motion for partial summary judgment.

Value of the *Garnett* and *Thompson* Opinions

Garnett and *Thompson* bring good news to taxpayers who own interests in LLPs and LLCs. Under *Garnett*, a member of an LLC or LLP, like a general partner, may satisfy any one of the seven tests for material participation under the temporary Code Sec. 469 regulations. As explained earlier, the Tax Court is a court of national jurisdiction because a taxpayer may petition the Tax Court for review of a notice of deficiency, regardless of the state in which the taxpayer resides.⁵² If the IRS challenges the status of an LLP or LLC member as a general partner for purposes of Code Sec. 469(h)(2), the taxpayer may forego paying the tax and petition the Tax Court, which is highly likely to hold that the member is a general partner. The Tax Court generally follows its own precedent in every circuit in the United States unless a Court of Appeals overrules its opinion. If an appellate court overrules the *Garnett* opinion,⁵³ the Tax Court will follow the ruling only in that circuit to which an appeal would lie.⁵⁴ In all other circuits, the Tax Court will follow its own precedent unless and until Congress, the U.S. Supreme Court or the Tax Court itself overturns the earlier opinion.⁵⁵

The Court of Federal Claims is a court of national jurisdiction in that a taxpayer may file a claim for a refund of tax in the Court of Federal Claims regardless of the state in which the taxpayer resides.⁵⁶ Thus, an LLC member, who has paid a tax based on the IRS’s determination that the member was a limited partner and, therefore, the member’s share of the LLC’s loss was disallowed, may sue for a refund in the Court of Federal Claims and rely on *Thompson* for a ruling that the member is a general partner for purposes of determining whether the member has materially participated in the LLC’s business. An opinion of the Court of Federal Claims is precedent unless or until it is overruled by Congress, the U.S. Supreme Court, the U.S. Court of Appeals for the Federal Circuit,⁵⁷ or another opinion issued by the Court of Federal Claims.

Moreover, the *Garnett* and *Thompson* opinions are persuasive. Both courts relied on the same legislative history as the *Gregg* court in reaching the same conclusion as was reached in *Gregg*. It is likely that

Congress intended the *per-se* rule of Code Sec. 469(h)(2) to apply to limited partners because of state law constraints on a limited partner's ability to participate in the partnership's business. In contrast, the LLP and LLC statutes of every state anticipate that LLP and LLC members will materially participate in the entity's business. In most states, an LLP is a general partnership that has registered or filed a form with the state to protect its members from unlimited liability for partnership debts and obligations.⁵⁸ While some state laws expressly or tacitly allow a limited partnership to register as a limited liability limited partnership (LLLP), the *Garnett* case only involved general partnerships that had filed to become LLPs. Similarly, most LLC statutes provide that an LLC is managed by its members unless the LLC's organizational documents provide for management by managers.⁵⁹ Even if an LLC is manager-managed, like the LLCs in *Garnett* and *Thompson*, there is no LLC statute that will cause an LLC member to lose its limited liability for engaging in the control of the LLC's business.

Furthermore, the limited liability shield that applies to LLP and LLC members is the same as the limited liability shield that applies to S corporation shareholders. Like an LLP or LLC that is classified as a partnership for federal tax purposes, an S corporation is a "passthrough" entity. In other words, an S corporation, like a partnership, generally does not pay tax on its income.⁶⁰ Instead, each S corporation shareholder includes on its individual income tax return the shareholder's *pro rata* share of items of the S corporation's income, gain, loss, deduction and credit.⁶¹ Like a partner who is an individual, trust or estate, an S corporation shareholder who is an individual, trust or estate is subject to the passive activity loss rules under Code Sec. 469.⁶² Nevertheless, there never has been a question as to whether an S corporation shareholder is a limited partner, notwithstanding the shareholder's limited liability. An S corporation is not a partnership for federal tax purposes, and therefore, an S corporation shareholder is not a limited or general partner. There does not seem to be a good reason to treat an LLP or LLC member differently than an S corporation shareholder for purposes of the material participation rules.

The *Thompson* and *Gregg* courts offered another reason to treat LLC members as general, rather than limited, partners. Under state law, a limited partnership must have at least one general partner who is personally liable for partnership debts and obliga-

tions. The *Gregg* court reasoned that if an LLC is treated as a partnership for tax purposes and each partner that has limited liability is treated as a limited partner, the partnership cannot be a limited partnership because there is no partner that has personal liability. The same rationale applies to a general partnership that is registered as an LLP.

Nevertheless, the legislative history of Code Sec. 469(h)(2) does not explicitly state Congress' intent to treat owners of interests in "substantially similar entities" to be treated as general, rather than limited partners. In enacting Code Sec. 469, Congress was particularly concerned that limited partnerships were commonly used as vehicles for marketing tax benefits to investors seeking to shelter unrelated income. The legislative history highlights the similarity between limited partners and shareholders in C corporations who are not permitted to use corporate losses to offset income from other activities.⁶³ Like a shareholder who invests in C corporation stock as an investment, a limited partner who does not materially participate in the partnership's business generally must wait to recognize his or her actual economic loss from the investment under the passive activity loss rules until the limited partner completely disposes of the interest in the partnership⁶⁴ or the partner's share of the partnership's net business income in later years equals the total losses allocated to the limited partner during the entire period that the limited partner held the partnership interest.⁶⁵

The *Garnett* and *Thompson* courts did not quote the full language of the Senate Report concerning the *per-se* rule for limited partners under Code Sec. 469(h)(2). The Senate Report explains:

In the case of a limited partnership interest, except to the extent provided by regulations, it is conclusively presumed that the taxpayer has not materially participated in the activity. In 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.

Under the bill, the Secretary of the Treasury is empowered to provide through regulation 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. It is intended that this grant of authority be used to prevent taxpayers from manipulating the rules that limited partnerships generally are passive, in attempting to evade the passive loss provision.

The exercise of such authority by the Secretary would also be appropriate if taxpayers were permitted under State law to establish limited liability entities (that are not taxable as corporations) for personal service or other active businesses, and to denominate as “limited partnership interests” any interests in such businesses related to the rendering of personal services. The exercise of such authority might also be appropriate where taxpayers sought to avoid limited partnership status with respect to substantially equivalent entities.⁶⁶

While the *Thompson* court determined that an LLC is not the type of entity “substantially equivalent” to a limited partnership as contemplated by the legislative history, both the legislative history and, more importantly, the statute⁶⁷ give the Treasury Department broad discretion to define the terms under which a member of a limited liability entity (not taxable as a corporation) will be treated as materially participating in the entity’s business activities. Code Sec. 469 explicitly authorizes the Treasury to prescribe regulations that specify what constitutes material participation.⁶⁸ The temporary material participation regulations carry out Congress’s mandate by providing special rules that apply to persons who hold “limited partnership interests” within the meaning of the regulations. Nevertheless, as the *Garnett* and *Thompson* courts noted, both Code Sec. 469(h)(2) and the temporary Code Sec. 469 material participation regulations require an individual to hold a limited partnership interest as a limited partner. If an LLP or LLC member holds a limited partnership interest but, at the same time, is a general partner, then the *per-se* rule of Code Sec. 469(h)(2) does not apply to the member.⁶⁹

As explained above, the designation of an LLP or LLC member as a *per-se* limited partner may be questionable as a matter of tax policy. There probably is no good reason to require a higher standard of participation for LLC members than is required of S corporation shareholders to establish material participation. Like LLP and LLC members, S corporation shareholders enjoy limited liability regardless of whether they

participate in the management of the business. Nevertheless, S corporation shareholders are not treated as limited partners under the material participation regulation because they are not “partners.”

On the other hand, it might be appropriate to require a higher standard of participation by an LLP or LLC member than an S corporation shareholder because LLP and LLC members enjoy more tax sheltering opportunities than S corporation shareholders. Unlike an S corporation shareholder, a member of an LLP or LLC is permitted to include the member’s share of LLP or LLC liabilities in the adjusted basis of the member’s interest in the entity.⁷⁰ A member of an LLP or LLC may use its distributive share of the entity’s losses to reduce income from other sources only to the extent of the adjusted basis of their interests in the entity.⁷¹ Similarly, an S corporation shareholder may deduct its *pro rata* share of the S corporation’s losses to reduce income from other sources only to the extent of the adjusted basis of the shareholder’s stock and any indebtedness of the corporation to the shareholder.⁷² The larger amount of basis afforded to a LLP and LLC members permits them to use a larger amount of losses to offset income from other sources than would be available to S corporation shareholders. Thus, the passive activity loss rules serve a more important function in limiting an investor’s ability to deduct LLP or LLC losses than is required in limiting deduction of losses available to an S corporation shareholder.

The Senate Report indicates that Congress intended special rules to apply to limited partners for many reasons, including the fact that limited partnerships had commonly been used as vehicles for marketing tax benefits to investors seeking to use their distributive shares of partnership losses to shelter income from other sources, including their salaries.⁷³ Congress might have intended to permit general partners to deduct a larger portion of partnership losses than limited partners because general partners are personally liable for partnership debts. Because of his or her exposure to liability for partnership debts and obligations, an individual who is a general partner is less likely to invest in a partnership for tax sheltering purposes than a partner whose liability is limited.

Nevertheless, there is no way of knowing exactly what Congress had in mind when it enacted Code Sec. 469(h)(2). Moreover, the committee reports cited in *Thompson* indicate that in enacting anti-tax shelter legislation like Code Sec. 469, Congress

was more concerned with the inability of a limited partner to participate in the management and control of the limited partnership's business than with the fact that a limited partner had limited liability under state law. Indeed, the legislative history of Code Sec. 469(h)(2) places more emphasis on those restrictions than on the limited liability shield provided to limited partners. As of this writing, three courts, the District Court for the District of Oregon, the Tax Court and the Court of Federal Claims have set forth persuasive arguments and reasons for other courts to adopt their interpretation of the statute. To date, no court has issued an opinion that is inconsistent with the opinions in *Garnett* and *Thompson*. It is hoped that the appellate courts will adopt the same interpretation of Code Sec. 469(h)(2).

The scope of the precedential value of the *Garnett* and *Thompson* opinions, however, is limited. *Garnett* and *Thompson* only resolve the issue concerning the status of an LLP or LLC member for purposes of Code Sec. 469(h)(2). There are other provisions of the Code under which the characterization of an LLP or LLC member as a limited or general partner may make an important difference in the tax consequences to the member. *Garnett* and *Thompson* may provide some guidance for interpreting some, but not all, of those provisions. Part II of this column will discuss the other provisions, whether *Garnett* or *Thompson* may offer guidance on the treatment of an LLP or LLC member under those provisions, and offer some suggestions for determining whether such a member should be treated as a limited or general partner under other provisions of the Code.

ENDNOTES

¹ *P.D. Garnett*, 132 TC No. 19 (June 30, 2009).
² *J.R. Thompson*, FedCl, 2009-2 USTC ¶50,501.
³ Code Sec. 469(a)(1)(A), (d)(1).
⁴ Code Sec. 469(a)(1)(B), (d)(2).
⁵ *S.A. Gregg*, DC-OR, 2001-1 USTC ¶50,169, 186 FSupp2d 1123.
⁶ The record in *Garnett* indicated that Mr. Garnett primarily, if not entirely, was the owner of each of the interests in the business organizations described in the case. The parties generally referred to the various ownership interests as belonging to both Mr. and Mrs. Garnett. For clarity and convenience, the *Garnett* opinion and this column also refer to both Mr. and Mrs. Garnett as the owners.
⁷ See Code Sec. 469(a)(1)(A) (disallowing a "passive activity loss"), and Code Sec. 469(d)(1) (defining the term "passive activity loss" as the amount by which the aggregate losses from all passive activities for the year exceed the aggregate income from all passive activities for such year).
⁸ Code Sec. 469(b).
⁹ Code Sec. 469(a)(1)(b), (d)(2).
¹⁰ Code Sec. 469(b).
¹¹ Code Sec. 469(a)(2).
¹² Code Sec. 469(c)(1).
¹³ Code Sec. 469(c)(2), (4).
¹⁴ Code Sec. 469(c)(3), (4).
¹⁵ Code Sec. 469(h)(1).
¹⁶ Code Sec. 469(j)(1).
¹⁷ See Temporary Reg. §1.469-5T(a)(1)-(7).
¹⁸ Temporary Reg. §1.469-5T(c).
¹⁹ Temporary Reg. §1.469-5T(b)(2)(iii).
²⁰ Temporary Reg. §1.469-5T(e)(2). If a taxpayer owns both a limited partnership interest and a general partnership interest in the same partnership at all times during the tax year, however, the taxpayer will not be treated as a limited partner.
²¹ Temporary Reg. §1.469-5T(e)(3)(i)(B).

²² *Garnett*, *supra* note 1, citing 1 Bromberg & Ribstein, Partnership §1.01(b)(5) (1998).
²³ *Garnett*, *supra* note 1, citing 1 Bromberg & Ribstein, Partnership §1.01(b)(4) (1998).
²⁴ Temporary Reg. §1.469-5T, TD 8175, 53 FR 5725 (Feb. 25 1988) 1988-1 CB 191, amended without reference to LLPs or LLCs by T.D. 8253, 54 FR 20527 (May 12, 1989), 1989-1 CB 121; TD 8417, 57 FR 20759 (May 15, 1992), 1992-1 CB 173.
²⁵ The following discussion appears at *Garnett*, *supra* note 1, citing Iowa Code Ann. §488.102(10), (12); 1 Bromberg & Ribstein, Partnership §1.01(b)(3) (1998); 3 Bromberg & Ribstein, *supra*, §11.02(c).
²⁶ Rev. Uniform Partnership Act (RUPA) §306(c); Iowa Code §§486A.101(5), 486A.306(3), 486A.1001.
²⁷ See Iowa Code Ann. §486A.201 (West 1999) (an LLP continues to be the same entity that existed before the filing of a statement of qualification).
²⁸ In general, directors, rather than shareholders, have the authority to exercise all corporate powers, business and affairs of a corporation. Model Business Corp. Act §8.01(b) (directors control operations of the corporation). The Model Business Corporation Act allows shareholders to enter into an agreement eliminating the board of directors or restricting the discretion of the board of directors. Model Business Corp. Act §7.32(a)(1). Iowa has adopted similar provisions to those of the Model Business Corporation Act regarding the authority of corporate directors and shareholders. See Iowa Code Ann §490.732(1)(a) (shareholders may agree to eliminate board of directors or restrict their authority), 490.801(2) (directors generally have the authority to exercise corporate powers and manage corporation's business).

²⁹ Rev. Uniform Ltd. Liability Co. Act (RULLCA) §407(a) (LLC is member-managed unless the operating agreement provides for management by managers); Iowa Code Ann. §490A.702(1) (unless articles of organization provide otherwise, LLC is managed by its members).
³⁰ RULLCA §304(a) (debts, obligations or other liabilities of an LLC do not become debts, obligations or other liabilities of a member or manager solely by reason of the member or manager acting as a member or manager); Iowa Code Ann. §490A.603(1) (LLC members generally not personally liable for LLC's debts or obligations), §490A.603(2) (liability of an LLC member same as liability of corporate shareholder).
³¹ See Reg. §301.7701-3(a) (business entity that is not classified as a corporation under Reg. §301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8) (the "per se corporations" under the check-the-box regulations) is an eligible entity that may elect to be classified as a partnership for federal tax purposes if the entity has two or more members). An LLC that is not a *per se* corporation and has only one member is eligible to elect to be classified as an entity that is not separate from its owner. Reg. §301.7701-3(a). The activities of a single-member LLC that is classified as such a so-called disregarded entity are in treated in the same manner as a sole proprietor, branch or division of the owner. Reg. §301.7701-2(a).
³² Reg. §301.7701-3(b)(1)(i). A domestic LLC with only one member is classified as a disregarded entity unless it elects to be classified as a corporation for federal tax purposes. Reg. §301.7701-3(b)(1)(ii).
³³ Reg. §301.7701-3(b)(1). If such an "eligible entity" has only one member, it does not have to make any election to be classified as

- a disregarded entity. Reg. §301.7701-3(b)(1)(ii).
- ³⁴ Temporary Reg. §1.469-5T(e)(3)(i)(B).
- ³⁵ Proposed regulations issued in 1997 provide a definition of the term "limited partner" "solely for purposes of Code Sec. 1402(a)(13)," concerning the treatment of a limited partner's distributive share of partnership income for purposes of the self-employment tax. Proposed Reg. §1.1402(a)-2(h), 62 FR 1704 (Jan. 13, 1997), 1997-1 CB 770. The proposed regulations provide no reference to LLP or LLC members. Moreover, the proposed regulations were never issued in final form and will not be effective unless or until they are so issued. Proposed Reg. §1.1402(a)-(j).
- ³⁶ *Garnett*, *supra* note 1, citing S. REP. NO. 99-13 732, 99th Cong., 2d Sess. (1986).
- ³⁷ S. REP. NO. 313, 99th Cong. 2d Sess. 731-32 (1986).
- ³⁸ Temporary Reg. §1.469-5T(e)(3)(ii).
- ³⁹ Temporary Reg. §1.469-5T(e)(3)(iii).
- ⁴⁰ The IRS relied on *Giles v. Vette*, 263 U.S. 553, 560 (1924) for its definition of general partner. The *Vette* case, however, did not concern the issue of whether the individuals in question were general or limited partners, but instead, concerned whether a partnership had been formed. The *Garnett* court was not persuaded by the IRS's reliance on *Vette*. *Garnett*, *supra* note 1.
- ⁴¹ S. REP. NO. 313, 99th Cong., 2d Sess. 720 (1986).
- ⁴² S. REP. NO. 313, 99th Cong., 2d Sess. 731 (1986).
- ⁴³ *Garnett*, *supra* note 1.
- ⁴⁴ *Garnett*, *supra* note 1, citing *Gregg*, *supra* note 5.
- ⁴⁵ *Thompson*, *supra* note 2, citing *Gregg*, *supra* note 5; Alan Bromberg & Larry Ribstein, Bromberg and Ribstein on Partnership §1.01(b)(3).
- ⁴⁶ *Thompson*, *supra* note 2.
- ⁴⁷ *Thompson*, *supra* note 2, citing Joint Committee on Tax'n, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Shelters and Minimum Tax 2 (1985).
- ⁴⁸ Joint Committee on Tax'n, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Shelters and Minimum Tax 2 (1985).
- ⁴⁹ *Thompson*, *supra* note 2, citing Joint Committee on Tax'n, General Explanation of the Tax Reform Act of 1986, 213 (1986).
- ⁵⁰ *Thompson*, *supra* note 2.
- ⁵¹ See Tax Court Rule 121(d).
- ⁵² Code Secs. 6213, 6512(b).
- ⁵³ The U.S. Courts of Appeals have jurisdiction to review Tax Court cases. Code Sec. 7482(a). In general, an individual petitioner seeking review of a Tax Court opinion will file a petition with the U.S. Court of Appeals for the circuit in which the taxpayer's legal residence is located. Code Sec. 7482(b)(1)(A). A corporation generally files a petition for review in the circuit in which the corporation's principal place of business, agency or office in which the corporation's tax return was made. Code Sec. 7482(b)(1)(B).
- ⁵⁴ *J.E. Golsen*, 54 TC 742, Dec. 30,049 (1970), *aff'd*, CA-10, 71-2 USTC ¶9497, 445 F2d 985, *cert. denied*, 404 US 940, 92 S Ct 284 (1971).
- ⁵⁵ *Id.*
- ⁵⁶ See, e.g., Code Sec. 6110(j).
- ⁵⁷ The U.S. Court of Appeals for the Federal Circuit has jurisdiction to hear appeals from decisions of the U.S. Court of Federal Claims. 28 USC §1295(a). See also H.R. REP. NO. 312, 97th Cong., 1st Sess. 16 (1982), *reprinted in* IRB 1982-24, 52, 53.
- ⁵⁸ RUPA §306(b), 1001.
- ⁵⁹ See RULLCA §407 (LLC is member-managed unless the operating agreement provides otherwise). As of June 2008, the only states whose LLC statutes provide that an LLC is managed by managers, rather than by members, unless the LLC's governing documents provide otherwise were Minnesota, North Dakota, Oklahoma, Tennessee and Texas. See 1 Larry E. Ribstein & Robert R. Keatinge, Ribstein and Keatinge on Limited Liability Companies Appendix 8-2 (2d ed. 1997, June 2008 Supp.) (table listing LLC statutes concerning rules for management of an LLC by members or managers).
- ⁶⁰ Compare Code Sec. 701(a) (partnership does not pay tax on its income) with Code Sec. 1363(a) (S corporation generally does not pay tax on its income). An S corporation may be required to pay a built-in gains tax on the sale or exchange of property it held at a time when the corporation was a C corporation or it received from a C corporation in a tax-free reorganization. See generally Code Sec. 1374. An S corporation also may have to pay tax on certain net investment income if the S corporation has accumulated earnings from the time the corporation was a C corporation or that it acquired in a tax-free reorganization with a C corporation. See generally Code Sec. 1375. If a corporation has been an S corporation since its inception and never engaged in a tax-free reorganization with a C corporation, the S corporation will not pay tax on its own income.
- ⁶¹ Code Sec. 1366(a).
- ⁶² Code Sec. 469(a)(2)(A). Closely held C corporations and personal service corporations that are partners also are subject to the passive activity loss rules with respect to their shares of partnership losses. Code Sec. 469(a)(2)(B), (C). Such entities, however, may not own stock in an S corporation. Code Sec. 1361(b)(1)(B). Thus, the application of the passive activity loss rules with respect to losses of an S corporation have no relevance for closely held C corporations or personal service corporations.
- ⁶³ S. REP. 313, 99th Cong., 2d Sess. 717 (1986).
- ⁶⁴ To recognize the loss, the limited partner or other investor in a passive activity must dispose of the interest in the activity in a fully taxable transaction, and not in a transfer to a related person. Code Sec. 469(g)(1).
- ⁶⁵ Code Sec. 469(b).
- ⁶⁶ S. REP. NO. 313, 99th Cong., 2d Sess. 731-32 (1986). (Footnotes omitted.)
- ⁶⁷ Code Sec. 469(h)(2) (except as provided in regulations, no interest as a limited partner shall be treated as an interred with respect to which a taxpayer materially participates).
- ⁶⁸ Code Sec. 469(l)(1).
- ⁶⁹ Temporary Reg. §1.469-5T(e)(3)(ii).
- ⁷⁰ Code Secs. 722, 752(a).
- ⁷¹ Code Sec. 704(d).
- ⁷² Code Sec. 1366(d).
- ⁷³ S. REP. NO. 313, 99th Cong., 2d Sess. 718 (1986).

This article is reprinted with the publisher's permission from the TAXES—THE TAX MAGAZINE, a monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the TAXES—THE TAX MAGAZINE or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.