NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

PROPOSED REGULATIONS
UNDER SECTION 469
GOVERNING THE DEFINITION OF
LIMITED PARTNER

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New York State Bar Association Tax Section

PROPOSED REGULATIONS UNDER SECTION 469 GOVERNING THE DEFINITION OF LIMITED PARTNER

Introduction

This report[1] of the Tax Section of the New York State Bar Association provides comments on proposed regulations under Section 469 issued on November 28, 2011 (the "Proposed Regulations").[2] The Proposed Regulations modify the definition of limited partnership interest under the current regulations[3] for purposes of applying the special limitations of Section 469(h)(2) of the Code.[4] When these special limitations apply, a service partner is subject to more restrictive "material participation" standards under the current regulations than would otherwise apply for purposes of determining whether the partner can use "passive losses" of the partnership to shelter other income. Under the Proposed Regulations, an interest in an entity is classified as "an interest as a limited partner in a limited partnership" (hereinafter, an "LPI" or a "limited partnership interest") if the entity is a partnership for federal income tax purposes and the holder does not have "rights to manage" the entity.

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[2] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011).

[3] Treas. Reg. § 1.469-5T(e)(3).

[4] Unless indicated otherwise, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this report.

This report is divided into three parts. Part I contains a general summary and background of the current and proposed Section 469(h)(2) Regulations and related issues. Part II summarizes our recommended changes to the Proposed Regulations. Part III contains a detailed discussion of our recommendations.

I. Current Law

Section 469(a)(1) limits the ability of certain taxpayers to deduct losses from passive activities.[5] Section 469(c)(1) defines a "passive activity" as any trade or business activity other than an activity in which the taxpayer "materially participates."[6] Under Section 469(h)(1), a taxpayer is deemed to materially participate in an activity only if the taxpayer is involved in the activity on a regular, continuous, and substantial basis.[7] Section 469(h)(2) provides that "except 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."[8] Under Treas. Reg. §

[5] The limitations apply generally to individuals, estates, trusts, "closely held C corporations" and "personal service corporations." Section 469(a)(2).

[6] Rental activities are passive without regard to whether or not the taxpayer materially participates, subject to special rules that apply to rental real estate. Sections 469(b)(2), 469(b)(7).

[7] Certain limitations apply to the material participation standard. For example, an individual's work in connection with an activity is not treated as participation in the activity if such work is of a type not customarily done by an owner of the activity, and one of the principal purposes of performing the work is to avoid the passive loss limitations. Treas. Reg. § 1.469-5T(f)(2)(i). In addition, work done by an individual in his capacity as an investor in an activity is not treated as participation in the activity, unless the individual is directly involved in the day-to-day management or operations of the activity. Treas. Reg. § 1.469-5T(f)(2)(ii).

[8] According to the legislative history, Congress adopted this presumption because "under relevant Local 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." S. Rep. No. 99-313, at 731 (1986) (Report on the Committee on Finance, U.S. Senate, to accompany H.R. 3838). The legislative history also emphasizes the widespread use of limited partnerships at that time "as vehicles for marketing tax benefits to investors seeking to shelter unrelated income." *Id.* at 718. The legislative history states that "in light of the widespread use of limited partnership interests in syndicating tax shelters, the committee believes that losses from limited partnership interests should not be permitted, prior to a taxable disposition, to offset positive income sources such as salary." *Id.*

1.469-5T(a), an individual[9] generally is treated as materially participating in an activity for a taxable year if (and only if) the individual satisfies one of seven tests (hereinafter, the "One-of-Seven Tests)":

1. The individual participated in the activity for more than 500 hours during such year;

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 (including individuals who are not owners of interests in the activity);

3. The individual participated 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 (including individuals who are not owners of interests in the activity);

4. The activity is a "significant participation activity"[10] for the taxable 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 of the ten taxable years that immediately precede the taxable year;

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; 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.[11]

In the case of a limited partner, however, an individual may avoid the passive loss limitations of Section 469 only by satisfying tests (1), (5), or (6) above (hereinafter, the "One-of-Three Tests").[12]

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[9] Closely held C corporations and personal service corporations are subject to a different material participation standard, set forth in Section 469(h)(4).

[10] As defined in Treas. Reg. § 1.469-5T(c).

[11] In addition, under Treas. Reg. § 1.469-5T(b)(2)(iii), an individual must participate in the activity for more than 100 hours during a taxable year in order to qualify under this test. The fact that an individual satisfies the requirements of a participation standard other than the standard set forth in the regulations under Section 469 is not taken into account in determining whether the individual has materially participated under the facts and circumstances test. Treas. Reg. § 1.469-5T(b)(2)(i). Section 469(h)(3) provides an exception to this rule for certain retired farmers and surviving spouses of retired or disabled farmers.

[12] Treas. Reg. § 1.469-5T(e)(2).

The current regulations treat an interest as a limited partnership interest if (i) it is designated as a limited partnership interest in the certificate of limited partnership or the limited partnership agreement, or (ii) the holder of the interest has limited liability under the laws of the state in which the partnership is organized.[13] If a limited partner is also a general partner, however, the holder is not limited to the One-of-Three Tests and may avoid the limitations of Section 469 under the One-of-Seven Tests. Under this exception, a partnership interest held by an individual is not a limited partnership interest "if the individual is a general partner in the partnership at all times during the partnership's taxable year."[14] For several years, the Internal Revenue Service (the "Service") sought without success to treat members of an LLC as limited partners under the limited partner definition of the current regulations.[15]

On November 28, 2011, the Treasury Department ("Treasury") and the Service issued proposed regulations modifying the definition of an LPI for this purpose.[16] Under the Proposed Regulations, an interest is an LPI if --

(i) the entity is classified as a partnership for federal income tax purposes; and

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[13] Treas. Reg. § 1.469-5T(e)(3)(i).

[14] Treas. Reg. § 1.469-5T(e)(3)(ii). The relevant partnership taxable year is the 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). *Id.*

[15] In a number of cases, courts have concluded that a holder of an LLC interest is not a limited partner for purposes of Section 469(h)(2). Under this line of cases, therefore, LLC members could establish material participation under any of the One-of-Seven Tests. In *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2000), an Oregon district court held that the limited partnership test is not applicable to LLC members because LLC members may participate in the management of the LLC without losing their limited liability. In *Garnett v. Comm'r*, 132 T.C. 368 (2009), the Tax Court held that ownership interests in an LLC were exempt from classification as limited partnership interests by operation of the general partnership exception. Although LLC members and limited partners both have limited liability, the Court reasoned that LLC members more closely resembled general partners because they could participate in management, whereas limited partners could not. Most recently, the Tax Court in *Newell v. Comm'r*, T.C. Memo 2010-23, held on similar grounds that a managing member of an LLC fell within the general partner exception. In *Thompson v. U.S.*, 87 Fed. Cl. 728 (2009), the Court of Federal Claims concluded that an LLC member manager was not subject to the more restrictive One-of-Three test because, under local law, the entity was not a partnership and the taxpayer was not a limited partner.

[16] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011). This term corresponds to the statutory language in Section 469(h)(2).

(ii) "the holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement."[17]

The absence of rights to manage would therefore replace limited liability as the hallmark of an LPI. Whether an interest affords limited liability protection under local law will no longer be relevant.[18] Although the Proposed Regulations do not define "rights to manage," the preamble ("Preamble") states that "rights to manage include the power to bind the entity."[19]

In the Preamble, Treasury and the Service cite both the emergence of LLCs and the relaxation of local law constraints on the right of a limited partner to participate in management without exposing himself to personal liability as the bases for the modified definition.[20] Treasury and the Service noted that the current regulations were drafted at a time when most states operated under versions of the Uniform Limited Partnership Act of 1916,[21] which provided that limited partners could lose their limited liability protection if they participated in the control of the partnership.[22] Today, most states have adopted versions of the Revised Uniform Limited Partnership Act of 1985 ("RULPA").[23] Under RULPA, the Preamble states, limited partners may now participate in the management and control of a partnership without losing their limited

[17] Prop. Treas. Reg. § 1.469-5(e)(3)(i).

[18] All references to "local law" (or "state law") in this report refer to the law of the jurisdiction in which the entity is organized.

[19] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011). The Proposed Regulations also update the existing exception to the definition of a limited partnership interest that applies where an individual limited partner also holds a general partnership interest, to account for the new definition of LPI. *See* Treas. Reg. § 1.469-5T(e)(3)(ii); Prop. Treas. Reg. § 1.469-5(e)(3)(ii).

[20] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011).

[21] *Id.*

[22] UNIF. LTD. P'SHIP ACT § 7 (1916) (providing that "[a] limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.").

[23] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011).

liability protection.[24] In recognition of these changes, the Proposed Regulations therefore abandon limited liability and adopt the absence of rights to manage as the standard for determining whether a partnership interest is an LPI.[25]

II. Principal Recommendations

Although our primary recommendation is that Treasury and the Service revisit the fundamental question of whether the absence of rights to manage is the appropriate standard for defining a limited partner, if Treasury and the Service choose to retain this standard in final regulations, the following is a summary of our principal recommendations:

- Final regulations should clarify the meaning of "rights to manage under the law of the jurisdiction in which the entity is organized." Specifically, they should clarify whether the legal right of an individual partner to manage the entity under the default provisions of local law is sufficient -- in and of itself -- or whether, in addition, the governing agreement must not override those rights.

- If a holder of an interest is considered to lack rights to manage because the governing agreement limits his default local law rights to do so, final regulations should eliminate any inference that a state law general partner who is prohibited from exercising the same rights under the governing agreement cannot be a limited partner as well.

- Final regulations should clarify that rights to manage must exist at all times during the *shorter of* the entity's taxable year or the portion thereof during which the service partner owns an interest.

- Final regulations should provide a clear and workable definition of "rights to manage", with specific examples of the types of rights that do or do not qualify as rights to manage.

- Final regulations should provide that an interest qualifies as an LPI "if and only if" the definitional standards of the regulations are met.

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[24] *Id.*

[25] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011). The Preamble also notes that "[u]nder the Uniform Limited Liability Company Act of 1996, LLC members of member–managed LLCs do not lose their limited liability protection by participating in the management and conduct of the company's business." *Id.*

Given the developments in local law described in the Preamble, coupled with the general focus of the statute on material participation in *any* activity related to the operations of a trade or business without regard to its nature, we recommend that Treasury and the Service reconsider whether rights to manage should remain the touchstone for distinguishing an LPI from any other type of partnership interest. If Treasury and the Service accept this recommendation, they should consider the following possible alternatives:

- defining an LPI as any interest in an entity classified as a partnership for federal income tax purposes that provides the holder with limited liability under local law, but allow any holder of an LPI to establish material participation under any of the One-of-Seven Tests, excluding the facts and circumstances test;[26]

- defining an LPI as any interest in an entity classified as a partnership for federal income tax purposes that does not provide the holder with rights to manage, but allow any holder of an LPI to establish material participation under the same six tests as described above;

- eliminating any distinction between an LPI and any other form of partnership interest altogether, allowing all service partners to establish material participation under any of the One-of-Seven Tests.

III. Discussion

A. Abandonment of the Limited Liability Standard

We commend Treasury and the Service for abandoning limited liability as the touchstone for distinguishing an LPI from any other type of partnership interest. According to the legislative history, Congress presumed at the time of enactment that a limited partner (or other person) who actively participated in the business of an entity would do so at the risk of losing limited liability protection.[27] The current regulations reflect the same presumption. As described in the Preamble, however, intervening changes in local law regarding the right of a

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[26] *See* Treas. Reg. § 1.469-5T(a)(7).

[27] S. Rep. No. 99-313, at 731 (1986) (Report on the Committee on Finance, U.S. Senate, to accompany H.R. 3838).

limited partner to manage the business without exposing himself to unlimited liability, coupled with the emergence of LLCs and other entities taxable as partnerships, have largely invalidated this presumption.[28] In most cases, a member of an LLC,[29] a limited partnership,[30] or other entity taxable as a partnership may actively participate in the business without becoming subject to unlimited liability for the obligations of the business. Accordingly, continuing to use limited liability as the touchstone for applying the more restrictive One-of-Three Tests is no longer appropriate.[31]

B. Technical Comments on the Proposed Regulations

The Proposed Regulations continue to subject limited partnership interests to the more restrictive One-of-Three Tests, but modify the definition of a limited partnership interest for this

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[28] The Preamble states that "[t]oday many states have adopted a variation of the Revised Uniform Limited Partnership Act of 1985 ("RULPA"). Under RULPA, limited partners may participate *in the management and control* of the partnership without losing their limited liability." REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011) (emphasis added).

[29] Many state LLC statutes allow members to manage the LLC without losing limited liability. *See, e.g.*, DEL. CODE ANN. Tit. 6, § 18-303(a) (2011) (providing that no member or manager of an LLC shall be obligated personally for any debt, obligation or liability of the LLC solely by reason of being a member or acting as a manager); N.Y. LTD. LIAB. CO. LAW § 609(a) (Consol. 2011) (providing that no member, manager or agent of an LLC is personally liable for any debts, obligations or liabilities of the LLC solely by reason of being a member, manager or agent).

[30] Although RULPA, as amended in 1985, generally denies limited liability protection to a limited partner who participates in the "control of the business," it enumerates a list of activities that do not rise to this level, including broad management rights. Moreover, even if the limited partner *does* participate in control of the business, the partner is only liable to persons who transact business with the partnership in the mistaken belief that the limited partner is a general partner. REVISED UNIF. LTD. P'SHIP ACT § 303 (amended 1985). For example, among other things, the Delaware RULPA includes among its enumerated permissible activities acting or causing a general partner or any other person (i) "to take or refrain from taking any action …with respect to any matter, including the business of the partnership", (ii) "sell, exchange lease or mortgage any asset or assets of the limited partnership", (iii) "to incur, renew, pay or discharge any indebtedness of the limited partnership", (iv) "to serve on any committee of the limited partnership" and (v) "such other matters as are stated in the partnership agreement." DEL. CODE ANN. Tit. 6, § 17-303(b) (2011); s*ee also* CAL. CORP. CODE § 15903.03 (2010); N.Y. P'SHIP LAW § 121-303 (2012).

[31] In fact, the modern trend is to permit even greater participation by limited partners. The 2001 Uniform Limited Partnership Act, sometimes referred to as "Re-RULPA," eliminates control liability altogether, providing that "[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 participates in the management and control of the limited partnership." REVISED UNIF. LTD. P'SHIP ACT § 303 (2001).

purpose. As described above, an interest in an entity is treated as an LPI under the Proposed Regulations if (i) the entity is classified as a partnership for federal income tax purposes, and (ii) the holder of the interest does not have rights to manage the entity at all times during the entity's taxable year, both under local law *and* under the governing agreement.[32]

The first clause of the definition of an LPI under the Proposed Regulations would eliminate any requirement that the entity qualify as a limited partnership under local law.[33] Accordingly, an interest in an LLC or any other entity taxable as a partnership may qualify as an LPI. Given the developments in local law described above, we believe this is appropriate. Subjecting the holder of an LPI who provides otherwise identical services to more restrictive limitations on the use of passive losses merely because the underlying entity is a local law limited partnership rather than a local law LLC or other form of tax partnership is no longer consistent with the original purposes of Section 469(h)(2),

The second clause of the definition of an LPI under the Proposed Regulations introduces a new factor -- "rights to manage" -- for purposes of testing whether an interest in an entity is an LPI. Under the Proposed Regulations, an interest is an LPI if the holder of the interest has no rights to manage under the law of the jurisdiction in which the entity is organized[34] *and* under

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[32] Prop. Treas. Reg. § 1.469-5(e)(3)(i).

[33] Prior to the issuance of the Proposed Regulations, the Service had attempted to characterize membership interests in LLCs as limited partnership interests under the current regulations. In a number of cases, courts rejected this characterization. *See Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2000); *Thompson v. U.S.*, 87 Fed. Cl. 728 (2009); *Garnett v. Comm'r*, 132 T.C. 368 (2009); *Newell v. Comm'r*, T.C. Memo 2010-23.

[34] For an entity organized as a Delaware limited partnership or LLC, the law of Delaware controls the rights and obligations of the members. *See* DEL. CODE ANN. Tit. 6, §§ 17-1101(i) (2011) ("[a] partnership agreement that provides for the application of Delaware law shall be governed by and construed under the laws of the State of Delaware in accordance with its terms."); 18-1101(i) (2011) ("[a] limited liability company agreement that provides for the application of Delaware law shall be governed by and construed under the laws of the State of Delaware in accordance with its terms."). In other jurisdictions, it may not be as clear that that the law of the jurisdiction where the entity is organized always controls rather than, for example, the place where it does business.

the entity's governing agreement.[35] Accordingly, an interest will not be an LPI if the holder has rights to manage *either* under local law *or* under the governing agreement.[36]

One question raised by this definition is what it means to have rights to manage under local law. In particular, if local law grant rights to manage to a holder of an interest in the entity except as provided in the entity's governing agreement and the governing agreement in fact restricts the exercise of such rights, is the holder nevertheless considered to have "rights to manage" under local law?[37] We believe that Treasury and the Service intended the answer to this question to be no; that is, the holder would not be considered to have rights to manage and would therefore be treated as a limited partner.[38] In view of the ambiguity, however, we recommend that final regulations clarify whether such an interest is an LPI.

In regard to this question, we offer two observations. The first is that if a holder of an interest in an entity is considered to have rights to manage under local law regardless of any restrictions in the governing agreement on the exercise of such rights, then few (if any) interests in an LLC formed under a statute corresponding to the Revised Uniform Limited Liability Company Act ("RULLCA") would qualify as LPIs because RULLCA vests the right to manage

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[35] Prop. Treas. Reg. § 1.469-5(e)(3)(i). Note that the Proposed Regulations do not require that the interest itself convey rights to manage. It is sufficient that the holder possess such rights with respect to *any* interest in the entity. Prop. Treas. Reg. § 1.469-5(e)(3)(ii) (providing that an individual who holds, for example, both a local law general partnership interest as well as an LPI is not treated as holding an LPI).

[36] We note that the recently issued proposed regulations under Section 892 -- issued during the same month as the Proposed Regulations -- define an interest as "an interest as a limited partner in a limited partnership" if the holder does not have the requisite participation rights "under the law of the jurisdiction in which the partnership is organized *or* under the governing agreement." Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(B) (emphasis added). It is not clear to us whether the use of the word "or" rather than the word "and" here was deliberate and, if so, what purpose it would serve given the policy objectives of Section 892.

[37] *See* Amy Elliot, *IRS Might Clarify Limited Partner Interest Test*, 3 Tax Notes 280 (2012) (reporting on a discussion with Michala Irons of the Service, where the question was raised but not answered).

[38] Note that while the abandonment of the limited liability standard under the Proposed Regulations is based on local law developments regarding the rights and powers that *may* be granted to a member without exposing the member to unlimited liability (whether or not they are in fact actually granted under the governing agreement), we do not believe that Treasury or the Service intended that the second prong of the definition of an LPI would be satisfied merely on the basis of the right under local law to grant rights to manage in the governing agreement.

in the members by default.[39] On the other hand, because RULPA does *not* vest the right to manage in a limited partner by default,[40] the same interpretation would have the opposite effect in the case of a state law partnership formed under RULPA. We assume that Treasury and the Service did not intend to draw such a distinction between limited partnerships and LLCs. By contrast, if Treasury and the Service intended to treat a holder of a partnership interest as lacking rights to manage if the governing agreement restricts the exercise of any rights to manage otherwise granted under local law, then the second prong of the definition (i.e., rights under local law) would potentially come into play only when the governing agreement fails to address (or adequately address) the exercise of rights to manage by the holder.

Second, the former interpretation raises the question of whether the Proposed Regulations could ever classify a general partnership interest under state law as an LPI. Under both the RULPA and Revised Uniform Partnership Act ("RUPA"), although general partners have the right to manage by default, that right can be restricted by the governing agreement.[41] In this

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[39] REVISED UNIF. LTD. LIAB. CO. ACT § 407(a) (2006). *See also* DEL. CODE ANN. Tit. 6, § 18-402 (2011) ("[u]nless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members").

[40] Under RULPA, although rights to manage are not granted by default to limited partners, they may be granted in the limited partnership agreement. *See* REVISED UNIF. LTD. P'SHIP ACT § 303(b) (amended 1985) (enumerating participation rights that a limited partner may possess or exercise without being deemed to participate in control of the partnership). The official comments to this subsection state that "it is intended to provide a 'safe harbor' by enumerating certain activities which a limited partner *may* carry on for the partnership without being deemed to have taken part in control of the business" (emphasis added). *See also* DEL. CODE ANN. Tit. 6, § 17-303(e) (2011) (providing that the enumeration of rights that a limited partner may possess or exercise without losing limited liability "does not create rights or powers of limited partners…such rights and powers may be created only by a certificate of limited partnership, a partnership agreement or any other agreement or in writing, or other sections of this chapter").

[41] *See* REVISED UNIF. LTD. P'SHIP ACT § 403(a) (amended 1985) ("*[e]xcept as provided in this [Act] or in the partnership agreement*, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners." (emphasis added)). *See also* REVISED UNIF. P'SHIP ACT §§ 401 (1997) (governing partners' rights and duties, including management rights); 103(a) (providing that "[e]xcept as otherwise provided in subsection (b), relations among the partners and between the partners and the partnership are governed by the partnership agreement."); 103(b) (listing the subsections of R.U.P.A. that the partnership agreement may not vary, a list which does not include § 401). *See also* DEL. CODE ANN. Tit. 6, §§ 15-407(a) (2011) (stating that the partnership agreement may provide for different classes of partners "having such

regard, a general partnership interest is no different from a membership interest in an LLC formed under RULLCA.[42] We note that the Proposed Regulations state that a general partnership interest under state law is not an LPI,[43] even though it is impossible to reconcile that statement with any definition of an LPI that would ignore all rights to manage that a partner is prohibited from exercising under the governing agreement. If Treasury and the Service intended to define an LPI in this manner, therefore, they should eliminate any inference in final regulations that no general partnership interest under state law can be reclassified as an LPI.

Under the LPI definition, the rights to manage must exist "at all times during the entity's taxable year." Read literally, therefore, if an individual were to become a member of the entity in the middle of its taxable year, the membership interest would be an LPI regardless of the individual's level of activity during the year. We therefore recommend that final regulations clarify that rights to manage must exist at all times during the shorter of the entity's taxable year or the portion thereof during which the individual owned a membership interest in the entity.[44]

Although the Proposed Regulations use "rights to manage" as the linchpin of the definition of an LPI, they provide no guidance regarding the meaning of the term. The only guidance is provided in the Preamble, which merely states that it "include[s] the power to bind the entity."[45] The failure of the Proposed Regulations to provide such guidance will make the scope and application of the Proposed Regulations highly uncertain, as the term is susceptible to

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relative rights, powers and duties as the partnership agreement may provide," and that the "partnership agreement may provide that any partner or class or group of partners shall have no voting rights"); 15-401 (governing partners' rights and duties, including management rights); 15-103(a) (stating that "[e]xcept as otherwise provided in subsection (b), relations among the partners and between the partners and the partnership are governed by the partnership agreement"); 15-103(b) (listing the subsections of the Delaware R.U.P.A. that the partnership agreement may not vary, a list which does not include § 401).

[42] *See supra* note 39 and the accompanying text.

[43] Prop. Treas. Reg. § 1.469-5(e)(3)(ii).

[44] *See* Treas. Reg. § 1.469-5T(e)(3)(ii), which contains similar language.

[45] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011).

such widely differing interpretations. For example, if an LLC has a board of directors and the interest provides its holder with a right to a board seat (or the right to appoint and discharge a director), would that be sufficient to provide the holder with rights to manage? What if under the terms of an LLC agreement, the holder of an interest had a specific right to serve on an "advisory committee," and/or the holder is provided with broad consultation rights? Would those rights be sufficient to constitute rights to manage? Alternatively, what if under the terms of an LLC agreement, the holder of an interest has veto power over any "major decision" and the list of major decisions is very broad? Does that veto right constitute rights to manage? If not, would the conclusion be different if the LLC agreement also provided the holder with the right to recommend particular courses of action, subject to the agreement of the other key members, or as to day to day matters, subject to the agreement of the person designated as the manager?

In addition, while the Preamble provides that rights to manage include the power to bind the entity, this statement is missing from the actual text of the Proposed Regulations.[46] Moreover, it is not clear whether a holder *must* possess this power regardless of the breadth of any other rights to manage the holder may possess, or if the possession of this power is sufficient but not necessary if the holder has other rights to manage. We believe that making the power to bind a necessary condition would be too restrictive. Regardless of which interpretation Treasury and the Service intended, however, the meaning of "power to bind" will almost certainly raise similar issues to those described above regarding the required scope of such power. For example, what if a holder has a default power to bind under local law but that power is circumscribed (but not eliminated) by the terms of the governing agreement, or the holder's

[46] *Id.*

power to bind is granted only under the terms of the governing agreement, but subject to substantial limitations?[47]

As previously noted, the recently issued proposed regulations under Section 892 make the determination of whether an interest in an entity taxable as a partnership is an "interest as a limited partner in a limited partnership" by reference to whether the holder has "rights to participate in the management and conduct of the partnership's business."[48] In contrast to the Proposed Regulations, the proposed regulations under Section 892 provide more guidance as to the meaning of "rights to participate in management and conduct of a partnership's business." They provide that such rights do not include consent rights over extraordinary events, including the dissolution of the partnership, merger, or sale of substantially all of the assets of the partnership outside the ordinary course of business.[49] Given the nature of these exceptions, the proposed regulations under Section 892 suggest that the right to manage is a fairly low threshold. In a prior report, we recommended that Treasury and the Service establish a higher threshold for purposes of the proposed regulations under Section 892, and assume that Treasury and the Service intended a higher threshold for purposes of the Proposed Regulations as well.[50]

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[47] Under many state LLC statutes, LLC members may bind the entity without losing limited liability. *See, e.g.*, DEL. CODE ANN. Tit. 6, § 18-402 (2011) (providing that each member and manager has the authority to bind the LLC, unless otherwise provided in the LLC agreement); *id.* § 18-303(a) (providing for limited liability for members and managers); N.Y. LTD. LIAB. CO. LAW § 412(a)-(b) (2012) (providing that members of a member-managed LLC are agents of the LLC and may bind the LLC, but are not agents of the LLC and may not bind the LLC when management is vested in a manager, unless such authority has been delegated to the member by a manager or under the operating agreement); *id.* § 609(a) (providing for limited liability for members, managers and agents); CAL. CORP. CODE § 17157 (2010) (providing that members are agents of a member-managed LLC and can therefore bind the LLC, but that members are not agents of the LLC and cannot bind the LLC if the LLC is managed by a manager, in which case the managers of the LLC are agents of the LLC and may bind the LLC).

[48] Prop. Treas. Reg. § 1.892-5(d)(5)(iii)(B).

[49] *Id.*

[50] *See* New York State Bar Association Tax Section Letter on Proposed Regulations under Section 892 (Report No. 1257, February 2, 2012). The proposed regulations under Section 1402 also define "limited partner" for purposes of that Section. Under those regulations, an individual is not to be treated as a limited partner if the individual "(i) has personal liability…for the debts of or claims against the partnership by reason of being a partner;

Given these many uncertainties, we recommend that final regulations provide clear guidance regarding the precise meaning of rights to manage, with specific examples of the types of rights that will or will not qualify. In addition, although the Proposed Regulations provide that an interest is an LPI if the definitional standards of an LPI are met, they do not provide that an interest is an LPI "if and only if" the definitional standards are met. This leaves open the possibility that an interest might qualify as an LPI even if it does not satisfy the proposed definition, which we do not believe Treasury or the Service intended. Accordingly, we recommend that final regulations provide that an interest qualifies as an LPI "if and only if" the definitional standards of the regulations are met.[51]

C. Is "Right to Manage" the Correct Standard?

As described more fully above, the Proposed Regulations introduce the absence of management rights as the new hallmark of an LPI. With this change, an individual member of any entity classified as a partnership for federal income tax purposes may become subject to the more stringent One-of-Three Tests for material participation merely because her role within the organization is subordinate to the role of the management team. That such a service partner should be prohibited from claiming the tax benefit of her allocable share of the losses when the more senior management partners in the same organization (who may have provided far fewer hours of service) are not is difficult to reconcile with the purpose of the statute. We appreciate that Treasury and the Service may have adopted this criterion to discriminate between interests that are more akin to general partnership interests than limited partnership interests. We also

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(ii) has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or (iii) participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year." Prop. Treas. Reg. § 1.1402(a)-2(h)(2). Although Treasury and the Service should consider coordinating these definitions, we recognize it may be difficult to do so given the separate purposes of each Code provision.

[51] In this regard, we note that the "if and only if" terminology is used throughout other provisions of Treas. Reg. § 1.469-5T. *See, e.g.*, Treas. Reg. §§ 1.469-5T(a), 1.469-5T(c)(1), 1.469-5T(c)(2).

appreciate that Section 469(h)(2) by its terms only applies to a limited partnership interest. It is not clear, however, why a distinction based on rights to manage should be controlling, given both the intervening changes in state law described in the Preamble and the general emphasis of the statute on material participation in the operations of a trade or business without regard to the aspect of the trade or business to which those operations relate.

The passive activity limitations of Section 469 are intended to apply only to persons who do not materially participate in the trade or business activities of the entity. The regulations under Section 469 provide seven tests for material participation, the satisfaction of any one of which is generally sufficient to meet this requirement. Each test requires a factual inquiry into the actual level of participation by the individual holder, measured by time spent during the year as well as other factors. Section 469(h)(2) provides that a limited partner in a partnership is not treated as materially participating, except as provided in the regulations. According to the original legislative history, the basis for this exception is that Congress assumed at the time that material participation in the business generally exposed a limited partner to a greater risk of unlimited liability.[52] On this basis, the current regulations grant some measure of relief to limited partners, acknowledging that the strict application of Section 469(h)(2) to a limited partner who actually participates in partnership activities would not be consistent with the purposes of the statute. Indeed, in light of the exposure to unlimited liability under the laws in effect in most jurisdictions at that time, it may have been reasonable to restrict limited partners to those material participation tests that require a higher level of participation in the business, particularly given appropriate skepticism about whether the lower levels of participation of the other four tests under the current regulations would in fact be met upon full examination of the facts.

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[52] S. Rep. No. 99-313, at 731 (1986) (Report on the Committee on Finance, U.S. Senate, to accompany H.R. 3838).

As described in this report and in the Preamble, however, most limited partners may now participate in the activities of a limited partnership on a regular and continuous basis without exposing themselves to unlimited liability. The right to do so is even clearer in the case of members of an LLC. Given these developments, coupled with the policy objectives of the statute, we believe that the historical justification for imposing more restrictive material participation tests on limited partners is no longer valid.

By introducing rights to manage as a new standard, however, we believe the Proposed Regulations will create new discontinuities. Why should a service partner not be able to avail himself of all seven tests, regardless of whether or not he has rights to manage? Why should an individual who provides services sufficient to satisfy the second of the seven tests be treated as materially participating only if he has rights to manage that he may or may not exercise? The mere possession of management rights does not assure that the holder of such rights will participate any more in the activities of a partnership than a person who does not possess management rights. In fact, even if final regulations were to eliminate the distinction between limited and general partners on this (or any other) basis, a service partner would still have to establish material participation under one of the seven tests to avoid the passive loss limitations of Section 469, each of which requires actual participation in the activity.

We recognize that the legislative history to the statute identifies the then-pervasive use of limited partnerships as vehicles for syndicating tax shelters as a reason for the enactment of Section 469(h)(2) and that the same potential for abuse exists for LLCs.[53] In light of that potential, as well as the existence of Section 469(h)(2), we appreciate that Treasury and the Service may have felt constrained by the statute to impose more stringent requirements on

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[53] *See supra* note 8.

holders of interests who lack rights to manage, as those interests may be viewed as inherently more akin to a limited partnership interest than a general partnership interest. As stated in the Preamble, however, "limited partners under RULPA are now more akin to general partners and LLC members with respect to their rights in the management of the entity".[54] There is no longer any reason to presume, as was once the case with respect to the attribute of limited liability, that a limited partner (as well as a member of an LLC or other entity taxable as partnership) is subject to any limitation under local law by virtue of such status on actively participating in the business.

Accordingly, we urge Treasury and the Service to reconsider whether Section 469 should condition a taxpayer's right to claim otherwise usable losses from a partnership to shelter other income upon whether the taxpayer has rights to manage. Although we recognize that the government may harbor some residual concern that making all seven tests available to a partner with no rights to manage could lead to abuse, the focus of both the statute and the legislative history focus is on whether a partner actually participates in the business, not on whether a partner has rights to manage that she may or may not exercise.[55] Moreover, as described above, the introduction of this new and undefined term is likely to require significant additional guidance, none of which would be necessary if such rights were not dispositive. Similarly, it would avoid the need for case-by-case determinations that the governing documents of an entity

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[54] REG-109369-10, 76 Fed. Reg. 228, 72875 (November 28, 2011).

[55] In enacting section 469(h)(1), Congress stated that "to satisfy the material participation standard, the individual's involvement must relate to operations." S. Rep. No. 99-313, at 732 (1986) (Report on the Committee on Finance, U.S. Senate, to accompany H.R. 3838). The right to manage enjoyed no unique distinction as an indicator of material participation. Congress even counseled against a standard based on management, stating that "[p]articipation in management cannot be relied upon unduly, both because its genuineness and substantiality are difficult to verify." *Id.* at 734-735. Congress noted that "experience in applying existing legal standards confirms that a test based on participation in management is subject to manipulation and creates frequent factual disputes between taxpayers and the Internal Revenue Service." *Id.* at 734. Rather, the legislative history makes clear that "the performance of management functions generally is treated no differently than rendering other services or performing physical work with respect to the activity." *Id. See also* Treas. Reg. § 1.469-5T(a) (assigning no greater weight to management activities than other activities). Note, however, that rights to manage might be a factor taken into account under the facts and circumstances test (i.e., test (7)). *See* Treas. Reg. § 1.469-5T(b)(2)(ii).

do or do not grant rights to manage to an individual partner.[56] Finally, we note that if the definition of LPI under final regulations continues to depend on the actual terms of the governing agreement, a general partnership interest should be treated as an LPI if it otherwise satisfies the regulatory definition.[57]

Rather than import a brand new standard of uncertain scope into the definition of an LPI, we recommend that Treasury and the Service replace this standard with a broader but more objective one that imposes less onerous consequences on the taxpayer.

For example, Treasury and the Service could define an LPI as any interest in any entity classified as a partnership for federal income tax purposes that provides the holder with limited liability under local law, but allow any holder of an LPI to establish material participation under any of the One-of-Seven Tests, excluding the more subjective "facts and circumstances" test of Treas. Reg. § 1.469-5T(a)(7). This approach would avoid the need to define "rights to manage" and at the same time not unduly discriminate between members of state law limited partnerships, LLCs and other limited liability entities taxable as partnerships on the basis of legal attributes that do not limit active participation in the underlying trade or business. Given the developments in local law described in this report and the overall purpose of Section 469, we believe this alternative is consistent with the basic policy objectives of the statute and will be much easier to administer. Restricting access to the subjective facts and circumstances test would also leave intact the distinction between a limited partner and a general partner originally envisioned by Section 469(h)(2), preventing a limited partner from taking the position on his tax return that he meets the material participation requirements of the statute notwithstanding that he does not

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[56] Factual inquiries of this nature could also be avoided (or at least minimized) if final regulations were to ignore the governing agreement, limiting their inquiry to whether state or local law permits a holder of an interest to exercise management rights.

[57] *See supra* note 40 and accompanying text.

satisfy any of the objective tests. Finally, this approach would acknowledge the diminished validity of the original rationale for the limited partner exception in the first place.

Another alternative is for Treasury and the Service to retain the rights to manage standard, but permit any holder of an LPI to establish material participation under the same six tests described above. Although this approach would not eliminate the need for guidance on the meaning of "rights to manage", it would greatly diminish the significance of the definition.

Finally, Treasury and the Service could eliminate any distinction between an LPI and any other form of partnership interest altogether, allowing all service partners to establish material participation under any of the One-of-Seven Tests. Section 469(h)(2) provides broad regulatory authority to provide exceptions to the treatment of limited partners as passive investors. Indeed, Treasury and the Service have already exercised this authority. Although the preamble to the current regulations does not explain the basis for the existing exceptions,[58] the legislative history to the statute states that "[i]t is intended that this grant of authority be used to prevent taxpayers from manipulating the rule that limited partnerships generally are passive, in attempting to evade the passive loss provision," such as by attempting to treat income that is not passive as passive.[59] Under the statute, however, the grant of regulatory authority is not limited to curbing this sort of abuse. Section 469(l) grants broad authority to Treasury "to 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."

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[58] *See* T.D. 8175, 1988-1 C.B. 191.

[59] S. Rep. No. 99-313, at 731 (1986) (Report on the Committee on Finance, U.S. Senate, to accompany H.R. 3838).

Although some of our members expressed concern regarding the authority of Treasury and the Service to eliminate any special limitations on limited partners, other members believe that Treasury and the Service have ample authority to do so.[60]

[60] *See, e.g., Mayo Foundation for Medical Education and Research v. U.S.*, 131 S. Ct.704 (2011). In *Mayo*, the Supreme Court unanimously held that the "Chevron" deference once accorded by courts only to "legislative" regulations applies regardless of whether Treasury issued the regulations in question under a general or specific grant of congressional authority. Here, the statute not only fails to unambiguously define a limited partner, it grants specific regulatory authority to treat a limited partner as materially participating in a trade or business. Under such conditions, a court will not substitute its own judgment regarding the proper interpretation of a statute for the judgment of Treasury. Instead, it will uphold a regulation is valid so long as it represents a permissible construction of the statute. *See Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837, (1984).