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Are Members of LLCs “Limited Partners”?  

-by Neil E. Harl

Recent audit activity, particularly in the Plains states indicates that the Internal Revenue Service is becoming concerned once again about passive activity losses in the agricultural sector.¹ The focus seems to be on limited liability companies (LLCs) which have become a popular choice for organizing business and investment ventures.² The key question with LLCs and passive activity losses is whether a member of an LLC is considered for income tax purposes to be a limited partner.³

Unfortunately, the regulations are not clear on that point.⁴ The hybrid nature of LLCs – created with the tax treatment of a partnership but with the structural characteristics, including limited liability, of a corporation – has contributed to the uncertainty as to how the passive activity loss rules should be applied to LLCs.⁵

General passive activity limitations

Deductions from passive trade or business activities, to the extent the deductions exceed passive activity income (exclusive of portfolio income), in general may not be claimed against other income, only against passive activity income.⁶ An activity is considered to be a passive activity if the activity involves the conduct of a trade or business and the taxpayer does not materially participate in the activity.⁷ A taxpayer is treated as materially participating in an activity only if the person “is involved in the operations of the activity on a basis which is – (A) regular, (B) continuous, and (C) substantial.”⁸

Limited liability companies are not mentioned specifically in the statute⁹ or the regulations.¹⁰ However, the regulations do state 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.”¹¹ The passive activity loss regulations, while not referring to LLCs, do refer to limited partners in a limited partnership.¹² Under those regulations, losses arising from limited partnership interests are treated as arising from a passive activity unless a limited partner satisfies any one of three requirements – (1) the limited partner participates for more than 500 hours in the activity,¹³ (2) the limited partner materially participated in the activity for five or more of the ten preceding years¹⁴ or (3) the activity is a personal service activity in which the limited partner materially participated for any three preceding years.¹⁵

Status of an LLC

For federal income tax purposes, an LLC is considered a partnership.¹⁶ The regulations specify that a partnership interest is treated as a limited partnership interest if so

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² Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
designated in the organizational documents or the liability of the holder of the interest is limited to a fixed, determinable amount under state law such as the amount contributed to the entity.\textsuperscript{17} On the face of it, that passage in the regulations would indicate that the limited liability of an LLC member would result in each owner being treated as a limited partner if the focus is on liability of the LLC member for the obligations of the LLC. However, if the focus is on participation in management, the position of an LLC member is arguably not that of a limited partner inasmuch as a limited partner cannot be active in the partnership’s business and if a limited partner becomes active in management may lose the feature of limited liability.\textsuperscript{18} The Congressional Committee reports lend support to that interpretation.\textsuperscript{19}

In a case decided in 2000, Gregg v. United States,\textsuperscript{20} the court considered the question of whether a member of an LLC should be classified as a limited partner or general partner for passive activity loss purposes. The court took the position that the limited partnership test, which looked only to the limited liability feature under state law, is inappropriate when applied to an LLC and its members.\textsuperscript{21} The court noted that the LLC statutes have created a new and different type of entity that is distinguishable from a limited partnership. Accordingly, the limited partnership test is not applicable to all LLC members. The court recognized that LLCs are designed to permit members of LLCs to engage in active management of the business without losing their limited liability feature which can occur with a limited partner.

The court in Gregg v. United States\textsuperscript{22} held that, inasmuch as the regulations did not state that members of an LLC were to be treated as limited partners, it was inappropriate to treat LLC members as limited partners.\textsuperscript{23} The court made it clear that an LLC member could show material participation on the basis of the seven tests in the regulations\textsuperscript{24} rather than the higher standard specified in the regulations for limited partners.\textsuperscript{25}

**In conclusion**

The position of the court in Gregg v. United States\textsuperscript{26} opens up additional possibilities for meeting the material participation test under the passive activity loss rules including the test for situations requiring less than 500 hours of involvement during the year,\textsuperscript{27} the test for situations where the taxpayer puts more than 100 hours per year into the activity and the taxpayer’s participation is not less than that of any other individual,\textsuperscript{28} the “significant participation” test which permits aggregation of effort from more than one activity,\textsuperscript{29} and the “facts and circumstances” test.\textsuperscript{30} Those additional tests represent a significant advantage for an LLC organizational structure compared to a limited partnership if a member of an LLC is not treated as a limited partner.\textsuperscript{31}

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**FOOTNOTES**

5. See 4 Harl, Agricultural Law § 30.08[1][a][ii][D] (2008).
7. I.R.C. § 469(c)(1).
21. Id.
23. Id.