The Tax Court and the U.S. Court of Federal Claims agree: Members of LLCs and LLPs are not to be treated as limited partners

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In a decision in late June 2009, the United States Tax Court held that ownership interests in a limited liability company (LLC) or limited liability partnership (LLP) should not be treated as limited partners in a limited partnership. About a month later, the U.S. Court of Federal Claims decided a case that went a notch beyond the holding in the earlier Tax Court case. That provides major support for the view that the statute which states “...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” does not require members of LLCs and LLPs to be limited in how the material participation test can be met. That at least expands the opportunities to meet the material participation test to the seven tests that are ordinarily available to taxpayers rather than the three tests specified in the temporary regulations for limited partners, thus increasing the chances for meeting the required standard of material participation on a regular, continuous and substantial basis.

As noted below, the decision by the U.S. Court of Federal Claims goes a step further in favoring the taxpayer.

The regulatory framework
Losses from passive trade or business activities, to the extent deductions exceed passive activity income (exclusive of portfolio income), in general may not be claimed against other income, only against passive activity income. An activity is considered to be a passive activity if the activity involves...

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the conduct of a trade or business and the taxpayer does not materially participate in the activity. 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.” LLCs and LLPs are not mentioned specifically in the statute or the temporary regulations inasmuch as in 1986, when the passive activity statute was enacted, only two states (Wyoming in 1977 and Florida in 1982) authorized entities denominated as limited liability companies and LLPs did not come into existence until the 1990s.

As noted, the statute states that “. . . no interest as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.” The temporary regulations specify seven tests for material participation under the passive activity loss rules:

1. participation for more than 500 hours during the year,
2. for situations requiring less than 500 hours of involvement, “substantially all” of the participation in the activity,
3. more than 100 hours per year and the participation is not less than that of any other individual,
4. the aggregate participation in “significant participation” activities exceeds 500 hours,
5. material participation for five of the last ten taxable years in the activity,
6. for personal service activities, any three preceding taxable years and
7. material participation based on all of the facts and circumstances.

Farm taxpayers are permitted to qualify as materially participating if they participated materially for five or more years in the eight year period before retirement or disability.

The temporary regulations hold limited partners to three tests for material participation:

1. more than 500 hours during the year,
2. the limited partner materially participated in the activity for five or more of the ten preceding years and
3. for personal service activities, any three preceding years.

Position of LLCs and LLPs
In general, a partnership interest (and, for tax purposes, an LLC or LLP is considered a partnership) is treated as a limited partnership interest if so designated in the organizational partnership 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. However, a general partner who holds an interest in a limited partnership is not necessarily treated as a limited partner. As we noted in a 2008 article, the temporary regulations would seem to indicate that, if the focus is on limited liability of the LLC member for obligations of the LLC, an LLC member would be treated as a limited partner. However, if the focus is on participation in management, the position of an LLC member is different in that a limited partner cannot be active in the partnership’s business and if a limited partner becomes active in management, the limited partner may lose the feature of limited liability.

The Congressional Committee Reports lend support to that interpretation.

A case decided in 2000, Gregg v. United States, recognized that LLCs are designed to permit members 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 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. The court made it clear that an LLC member could show material participation based on the seven tests in the temporary regulations rather than the higher standard specified in the temporary regulations for limited partners.

Garnett v. Commissioner
The 2009 Tax Court case of Garnett v. Commissioner, citing Gregg v. United States, involved taxpayers who owned seven limited liability partnerships and two limited liability companies in Iowa, all engaged in farming and agribusiness operations. The LLP agreements provided that each partner would actively participate in the control, management and direction of the LLP’s business. The LLC operating agreements provided that business was to be conducted by a manager.

The Tax Court focused on the application of the “general partner exception” and believed the LLP and LLC members had the right to participate in management, as do general partners, which justified that exception inasmuch as state law did not preclude the members from actively participating in the management and
operations of the LLPs and LLCs. Accordingly, the members were entitled to apply all seven of the tests for material participation and were not limited to the three prescribed for limited partners.

The Internal Revenue Service had also treated two interests in tenancy in common as limited partnerships which the Tax Court rejected.

Thompson v. United States
The decision of the U.S. Court of Federal Claims, Thompson v. United States, cited approvingly both Gregg v. United States and Garnett v. Commissioner but went beyond those decisions in stating that the regulation “. . . is simply inapplicable to membership interests in an LLC.” That suggests that the current I.R.C. § 469 does not limit the losses in question.


The vertical integration of the hog industry was supposed to lead to a more efficient, rational use of resources at the integrator level and reduce the risks at the producer level through contracts. In late August 2009, the price for hogs in the Iowa-Southern Minnesota Direct hog trade was just over $45/cwt, compared to nearly $85/cwt a year earlier. Production costs have exceeded market costs in 20 of the last 22 months.

But it wasn’t supposed to happen this way. With contracts, the integrators were supposed to have greater control over the hog cycle than when there were a large number of small producers.

But things don’t always work out the way they were planned.

In the mid-1990s, the North American Free Trade Agreement (NAFTA) set the framework for an integrated North American hog industry just at the time that the Canadians abolished their Crow Rate grain transportation subsidy for grain that reduced the transportation cost of getting Western Canadian grain to markets.

With the elimination of the subsidy, these Western Canadian farmers began to cast about for an alternate way to protect their income. With the encouragement of the provinces they went into hog production, adding value to their locally produced grain and oilseeds. Hog production increased, and the number of feeder pigs sold into the US increased from less than a million head in 1995 to over 6 million head in 2008.

This is the same period in which the U.S. saw dramatic gains in production efficiency as the number of sows fell and production increased. The number of active producers also fell as many smaller operators got out of hog production and others grew in size.

This increase in production was needed to meet the growing export demand that zoomed from less than a billion pounds in 1995 to nearly 5 billion pounds in 2008. At the same time, U.S. consumption continued to increase, although not as rapidly as export demand.

As long as demand was booming, the hog industry was in good condition. However, it only takes a small change at the margin to trigger dramatic results.

Some of the new markets like Russia then decided that they needed to develop their own domestic pork industry. They did not want to be at the mercy of foreign suppliers for a commodity as important as pork, so they began to find ways to restrict their imports of pork and provide incentives to domestic producers.

The financial crisis that began in 2008 started to put economic pressure on US households to reduce their total expenses, and the consumption of pork fell by 1.7 percent from 2007 to 2008.