April 16, 2010

*By Email : Bryan.A.Rimmke@irscounsel.treas.gov*

Mr. Bryan A. Rimmke
IRS Office of Chief Counsel
Passthroughs and Special Entities
Washington, DC

RE: Possible Interim Guidance Regarding Classification of LLC Members as Limited Partners Under I.R.C. § 469(h)(2) following Action on Decision 2010-001, 2010-14 I.R.B. (March 9, 2010)

Dear Mr. Rimmke,

This letter is respectfully submitted by the National Business Aviation Association ("NBAA") to provide comments regarding possible interim guidance that the IRS is considering regarding the classification of members of limited liability companies as limited partners for purposes of the passive activity rules following Action on Decision 2010-001, 2010-14 I.R.B. (March 9, 2010). We appreciate the opportunity to submit the comments.

NBAA represents more than 8,000 Member Companies and is the leading organization for companies that own or operate general aviation aircraft to help make their businesses more efficient, productive and successful. NBAA is concerned that an expansive definition of limited partner under the passive activity rules could unfairly and arbitrarily prevent aircraft owners from deducting their transportation costs and that the application of such overly complex rules could create unnecessary administrative costs and uncertainty for aircraft owners.

In AOD 2010-001, the IRS acquiesced in result only to the holding in *Thompson v. United States*, 87 Fed. Cl. 728 (2009), that member interests in a limited liability company (LLC) are not limited partner interests for purposes of Treas. Reg. § 1.469-5T(e)(3)(i). Consistent with this AOD, NBAA recommends that any interim guidance issued by the IRS state that LLC member interests are not limited partner interests for purposes of I.R.C. 469(h)(2) and Treas. Reg. §§ 1.469-4(d)(3), -5T(e)(3). As discussed below, the special rules for limited partners in § 469(h)(2) were premised on the assumption that State law restricts limited partners' participation in the limited partnership's business. Since there is no such State law restriction on LLC members, the material participation of LLC members should be determined under the seven tests like other taxpayers.

The guidance should also explain that limited partners would not be subject to the special rules for limited partners under these provisions, if the limited partnership is formed in a state that has adopted the Revised Uniform Limited Partnership Act (2001) ("RULPA"), which provides that a limited partner can participate in the management and control of a limited partnership. The guidance should clarify that LLC members and limited partners in partnerships formed in states adopting RULPA will not be treated as limited entrepreneurs for purposes of Treas. Reg. § 1.469-4(d)(3).

*Background*

The passive activity loss limitations were enacted in I.R.C. § 469 as part of the Tax Reform Act of 1986. I.R.C. § 469(h)(2) provides that, except as provided in regulations, no interest "in a limited partnership as a limited partner" will be treated as an interest with respect to which the taxpayer materially participates for purposes of the passive loss limitations. The regulations provide two exceptions:

1. Treas. Reg. § 1.469-5T(e)(2) provides that a limited partner can be considered a material participant in an activity, if the limited partner meets one of the three material participation tests in Treas. Reg. § 1.469-5T(a)(1), (a)(5), or (a)(6). Thus only three of the seven material participation tests are available to limited partners.

2. Treas. Reg. § 1.469-5T(e)(3)(ii) provides that a limited partner who is also a general partner will not be treated as a limited partner.

Treas. Reg. § 1.469-5T(e)(3)(i) provides that "a partnership interest shall be treated as a limited partnership interest" if the interest is designated as a limited partnership interest in the limited partnership agreement or if the liability of the holder of the interest is limited under the law of the state in which the partnership is organized.

Several recent court decisions have held that since LLC interests are not limited partner interests in limited partnerships, all seven material participation tests are available to LLC members. *Newell v. Comm'r*, T.C. Memo (RIA) 2010-23; *Hegarty v. Comm'r*, T.C. Summary Op. 2009-153; *Thompson v. United States*, 87 Fed. Cl. 728 (2009); *Garnett v. Comm'r*, 132 T.C. No. 19 (2009); *Gregg v. United States*, 186 F. Supp. 2d 1123 (D. Ore. 2000). Several of these cases explain that even if the definition of limited partner was applicable to an LLC member, the LLC member's participation in management of the LLC would mean that the member acts as a general partner and therefore would not be treated as a limited partner due to the exception for limited partners who also hold general partner interests.

Due to the special rules for limited partners, Treas. Reg. § 1.469-4(d)(3) provides that limited partner interests (and limited entrepreneur interests as defined under I.R.C. § 464(e)(2)) held in certain activities identified in I.R.C. § 465(c)(1) may only be grouped with other activities that are in the same type of business. A limited entrepreneur is defined in § 464(e)(2) as a person other than a limited partner who does not actively participate in the management of an enterprise. Equipment leasing is one of the types of business specified in § 465(c)(1). Accordingly, this regulation may mean that an aircraft leasing activity by a limited partnership could not be grouped by a limited partner (or a limited entrepreneur (as defined in § 464(e)(2)) with respect to the leasing activity) with business activities other than equipment leasing.

*LLC Members Should Not Be Treated as Limited Partners Under the Passive Activity Rules*

Any interim guidance issued by the IRS should explain that LLC members are not to be treated as limited partners under the passive activity rules. As explained in the court cases cited above, § 469(h)(2) and Treas. Reg. § 1.469-5T(e)(3)(i) both refer to limited partners in limited partnerships, and an LLC member is not a limited partner in a limited partnership. Accordingly, the special rules for limited partners do not apply to LLC members.

In addition to the clear wording of the statute and regulations, the policy behind the provision supports not treating an LLC member as a limited partner. The special rule for limited partners in § 469(h)(2) was based on the premise that under State law limited partners could only participate in the activities of a limited partnership to a limited extent. In this regard, the Joint Committee's explanation of the Tax Reform Act of 1986 explains the purpose behind the special rule in § 469(h)(2) as follows:

> 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.

Staff of the J. Comm. on Tax'n, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 236 (P-H) (1987) (the "Blue Book"). In other words, Congress believed that a limited partner's level of participation in partnership activities was limited under State law, and that this fact was sufficient to support the determination that a limited partner was not a material participant in the partnership's activities. As discussed in *Thompson*, at the time of the Tax Reform Act of 1986, RULPA provided that a partner did not qualify for limited liability protection as a limited partner if he or she "participates in the control of the business." RULPA (1985) § 303(a).

In contrast, there is no limit on the ability of an LLC member to participate in the activities of an LLC. Since an LLC member's status as a member of an LLC does not indicate the individual's level of participation in the LLC, the LLC member's passive or nonpassive status should be determined under the seven tests for material participation like any other taxpayer.

There is no policy reason to conduct a separate evaluation of whether the LLC member participates in the management of the LLC. The purpose behind providing a special rule for limited partners in § 469(h)(2) does not apply to LLC members, because LLC members are not subject to a restriction under State law on their ability to participate in the management of the LLC by virtue of their status as LLC members. Accordingly, no useful policy is served by interpreting § 469(h)(2) as creating an additional material participation test for LLC members. For

example, imposing a requirement to evaluate whether an LLC member participates in the LLC in a manner similar to a general partner in a partnership would arbitrarily impose an additional requirement on an LLC member to qualify as a material participant in an activity. Therefore, the IRS should simply make it clear that the special rule for limited partners in § 469(h)(2) does not apply to LLC members.

*Limited Partners in RULPA States Should Not Be Treated as Limited Partners Under the Passive Activity Rules*

After the 1986 Act, RULPA was revised to provide that a limited partner may "participate[] in the management and control of the limited partnership." RULPA (2001) § 303. Whereas in the Tax Reform Act of 1986 limited partner status indicated the partner's level of participation in the activities of the partnership, it no longer provides any such indication for a partnership formed in a state that has adopted RULPA. Since the premise behind § 469(h)(2) is no longer applicable in RULPA states, it would serve the purposes of the statutory provision for Treasury to exercise its regulatory authority under § 469(h)(2) to exclude limited partners in RULPA states from § 469(h)(2). A similar exception should be made in the case of limited partners in non-RULPA states that permit limited partners to participate in the management and control of the partnership.

*LLC Members and Limited Partners in RULPA States Should Be Permitted to Group Activities In the Same Manner as Other Taxpayers*

Taxpayers are generally permitted to group multiple activities together for purposes of the passive loss rules under "any reasonable method" taking into account a list of five factors. Treas. Reg. § 1.469-4(c)(2). Under these rules, a taxpayer may group together activities conducted in different entities. Treas. Reg. § 1.469-4(a). In this regard, the Blue Book explains that—

> the fact that two undertakings are conducted by different entities does not establish that they are different activities. Rather, the activity rules generally are applied by disregarding the scope of passthrough entities such as partnerships and S corporations.

Blue Book at 236. After setting out this general rule, Congress noted that due to the special status of limited partners under the passive activity rules, an activity conducted as a limited partner should not be grouped with other activities. The Blue Book explains this concept as follows:

> With respect to limited partnerships, an additional rule applies in light of the special status of limited partnership interests with respect to material participation. An interest in a limited partnership is not treated as being part of the same activity as any activity in which the taxpayer is treated as materially participating.

Blue Book at 236. Treas. Reg. § 1.469-4(d)(3) implements this concept of providing a limitation on the grouping of activities by limited partners due to their special status. Treas. Reg. § 1.469-4(d)(3)(i) provides as follows:

> Except as provided in this paragraph, a taxpayer that owns an interest, as a limited partner or a limited entrepreneur (as defined in section 464(e)(2)), in an activity described in section 465(c)(1), may not group that activity with any other activity.

That regulation goes on to explain that a limited partner or limited entrepreneur would be permitted to group such activities with other activities of the same type of business. The above provision slightly expands the limitation suggested in the Blue Book by applying it to limited entrepreneurs as well as limited partners. It also narrows the limitation by only applying it to the types of activities described in § 465(c)(1). Apparently, Treasury felt that taxpayers meeting the definition of limited entrepreneurs should be subject to the same limitations as limited partners, and that this limitation should only be imposed on the activities singled out for special treatment under the at-risk rules in § 465(c)(1).

As discussed above, only limited partners in non-RULPA states should have special treatment under § 469(h)(2). Therefore, only these taxpayers should be subject to the grouping limitation under Treas. Reg. § 1.469-4(d)(3). Accordingly, any interim guidance should clarify that LLC members and limited partners in RULPA states are not to be treated as limited partners for purposes of the limitation on activity groupings in Treas. Reg. § 1.469-4(d)(3). In addition, since there is no special passive activity rule for limited entrepreneurs under § 469(h)(2), such interim

guidance should clarify that LLC members will not be treated as limited entrepreneurs for purposes of Treas. Reg. § 1.469-4(d)(3).

*Form of Guidance*

We anticipate that there are other constituencies that would be affected by interim guidance provided by the IRS on these issues. Before any such guidance is issued, we recommend that the IRS announce (possibly, in a news release or announcement) that it is considering these issues and seeks comments from the public. Once comments have been received and reviewed, we suggest issuing interim guidance (possibly in the form of a notice). In view of the importance of these issues to taxpayers, we recommend that Treasury open a regulations project and issue a notice of proposed rule-making to address these issues.

We appreciate the opportunity to provide comments with respect to these issues. If you have questions or require additional information, please contact me.

Sincerely,

Mike Nichols
Vice President, Operations, Education & Economics