

Passive Activity Losses and Credits Limited

[4830-01-p]

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

[REG-109369-10]

RIN 1545-BJ33

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the definition of an "interest in a limited partnership as a limited partner" for purposes of determining whether a taxpayer materially participates in an activity under section 469 of the Internal Revenue Code (Code). These proposed regulations affect individuals who are partners in partnerships.

DATES: Written or electronic comments and requests for a public hearing must be received by February 27, 2012.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-109369-10), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-109369-10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at [http://www.regulations.gov/\(IRS REG-109369-10\)](http://www.regulations.gov/(IRS REG-109369-10)).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Michala Irons, (202) 622-3050; concerning submissions of comments and requests for public hearing, Oluwafunmilayo Taylor, (202) 622-7180 (not toll free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 469(a)(1) limits the ability of certain taxpayers to deduct losses from passive activities. Section 469(b) permits passive losses disallowed in one year to be carried over to the next year. Section 469(c)(1) provides that a passive activity means any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate. Section 469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. The Treasury Department and the IRS promulgated temporary regulations under section 469 in 1988. See TD 8175, 53 FR 5686 (February 25, 1988). Section 1.469-5T(a) provides that an individual taxpayer shall be treated as materially participating in an activity for the taxable year if and only if:

- (1) The individual participates 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 (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 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 (including individuals who are not owners of interests in the activity) for such year;
- (4) The activity is a significant participation activity (within the meaning of § 1.469-5T(c)) 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 (determined without regard to § 1.469-5T(a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
- (6) The activity is a personal service activity (within the meaning of § 1.469-5T(d)), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in § 1.469-5T(b)), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Section 469(h)(2) presumptively treats losses from interests in limited partnerships as passive. 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. **Section 1.469-5T(e)(2) permits an individual taxpayer to establish material participation in a limited partnership but constrains the individual taxpayer to only three of the seven regulatory tests** in § 1.469-5T(a), (§ 1.469-5T(a)(1), (a)(5), or (a)(6)).

Section 1.469-5T(e)(3)(i) generally provides that a partnership interest shall be treated as a limited partnership interest if (A) such interest is either designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under applicable State law; or (B) the 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 (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership). However, even if the interest is characterized as a limited partnership interest under § 1.469-5T(e)(3)(i), an exception under § 1.469-5T(e)(3)(ii) applies if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest) (the "general partner exception"). If the general partner exception applies, the limited partnership interest will not be treated as such for the year in which the individual taxpayer is a general partner in the partnership. This allows the individual taxpayer to demonstrate material participation through any of the seven regulatory tests in § 1.469-5T(a).

Courts have concluded, in certain instances, that the holder of a limited liability company (LLC) interest is not treated as holding an interest in a limited partnership as a limited partner for purposes of applying the section 469 material participation tests. In Gregg v. U.S., 186 F.Supp.2d 1123 (D. Or. 2000), an Oregon district court concluded that, in the absence of regulations to the effect that an LLC member should be treated as a limited partner, the limited partner exception in section 469(h)(2) was not applicable

to LLC members. In **Garnett v. Comm'r**, 132 T.C. 368 (2009), the Tax Court found that the taxpayers' ownership interests in limited liability partnerships and LLCs were not interests in limited partnerships because their interests fit within the general partner exception in § 1.469-5T(e)(3)(ii). Shortly thereafter, in **Thompson v. U.S.**, 87 Fed. Cl. 728 (2009), the Court of Federal Claims concluded that the regulations under section 469(h)(2) require the taxpayer's ownership interest to be in a partnership under State law rather than a partnership under Federal income tax law. Accordingly, because an LLC member is not a limited partner under State law, the court concluded that section 469(h)(2) did not apply to an LLC member. Most recently, the Tax Court in **Newell v. Comm'r**, T.C. Memo. 2010-23, concluded that section 469(h)(2) did not apply to the managing member of an LLC and that the member fell within the general partner exception in § 1.469-5T(e)(3)(ii). On April 5, 2010, the IRS issued an Action on Decision acquiescing in the result only in **Thompson v. U.S.**, AOD 2010-02, 2010-14 I.R.B. 515.

Explanation of Provisions

The proposed regulations provide that an interest in an entity will be treated as an interest in a limited partnership under section 469(h)(2) if (A) the entity in which such interest is held is classified as a partnership for Federal income tax purposes under § 301.7701-3; and (B) 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 was organized and under the governing agreement. Rights to manage include the power to bind the entity. The proposed regulations provide rules concerning an interest in a limited partnership based on the purposes for which section 469 was enacted, and the manner in which the provision is structured and operates within the Code. Accordingly, the rules concerning an interest in a limited partnership in the proposed regulations are provided solely for purposes of section 469 and no inference is intended that the same rules would apply for any other provisions of the Code requiring a distinction between a general partner and a limited partner.

In **Garnett v. Comm'r**, *supra*, the Tax Court noted that Congress enacted section 469(h)(2) to address the limitations on a limited partner's ability to participate in the control of the partnership's business. Under the Uniform Limited Partnership Act of 1916, limited partners could lose their limited liability protection if they participated in the control of the partnership. The regulations under section 469(h)(2) were drafted with these constraints in mind. Today, 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. As a consequence, 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. Under the Uniform Limited Liability Company Act of 1996, LLC members of member-managed LLCs do not lose their limited liability by participating in the management and conduct of the company's business. In *Newell v. Comm'r, supra*, the Tax Court noted that the managing member of the LLC at issue managed the day-to-day operations of the LLC and was the "substantial equivalent" of a general partner. **Recognizing that the original presumptions regarding the limitations on a limited partner's participation in the activities of the entity are no longer valid today, and also recognizing the emergence of LLCs, the proposed regulations eliminate the current regulations' reliance on limited liability for purposes of determining whether an interest is an interest in a limited partnership as a limited partner under section 469(h)(2) and instead adopt an approach that relies on the individual partner's right to participate in the management of the entity.**

The regulations are proposed to apply to taxable years beginning on or after the date of publication of the Treasury decision adopting these regulations as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing

will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Michala Irons, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 -- INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.469-0 is amended by:

1. Revising the entries for § 1.469-5(a), (b), (c), (d), and (e).
2. Removing the entries for § 1.469-5T(e)(1), (e)(2), and (e)(3).

The revisions read as follows:

§ 1.469-0 Table of contents.

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§ 1.469-5 Material participation.

(a) through (d) [Reserved].

(e) Treatment of an interest in a limited partnership as a limited partner.

(1) In general.

(2) Exceptions.

(3) Interest in a limited partnership as a limited partner.

(i) In general.

(ii) Individual holding an interest other than an interest in a limited partnership as a limited partner.

(4) Effective/applicability date.

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Par. 3. In § 1.469-5, paragraphs (a), (b), (c), (d), and (e) are revised to read as follows:

§ 1.469-5 Material participation.

(a) through (d) [Reserved].

(e) Treatment of an interest in a limited partnership as a limited partner -- (1) In general. Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity in which the individual owns an interest in a limited partnership as a limited partner (as defined in paragraph (e)(3)(i) of this section) for purposes of applying section 469 and the regulations thereunder to --

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to an interest in a limited partnership as a limited partner; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) Exceptions. Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraphs (a)(1), (a)(5), or (a)(6) of § 1.469-5T if the individual did not own an interest in a limited partnership as a limited partner (as defined in paragraph (e)(3)(i) of this section) for such taxable year.

(3) Interest in a limited partnership as a limited partner -- (i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), an interest in an entity shall be treated as an interest in a limited partnership as a limited partner if --

(A) The entity in which such interest is held is classified as a partnership for Federal income tax purposes under § 301.7701-3; and

(B) 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.

(ii) Individual holding an interest other than an interest in a limited partnership as a limited partner. An individual shall not be treated as holding an interest in a limited partnership as a limited partner for the individual's taxable year if such individual also holds an interest in the partnership that is not an interest in a limited partnership as a limited partner (as defined in paragraph (e)(3)(i) of this section), such as a state-law general partnership interest, at all times during the entity's taxable year ending with or within the individual's taxable year (or the portion of the entity's taxable year during which the individual (directly or indirectly) owns such interest in a limited partnership as a limited partner).

(4) Effective/applicability date. This section applies to taxable years beginning on or after the date of publication of the Treasury decision adopting these rules as a final regulation in the **Federal Register**.

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Par. 4. Section 1.469-5T paragraph (e) is revised to read as follows:

§ 1.469-5T Material participation (temporary).

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(e) Treatment of Limited Partners. [Reserved]. See § 1.469-5(e) for rules relating to this paragraph (e).

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Par. 5. Section 1.469-9 paragraph (f)(1) is revised to read as follows:

§ 1.469-9 Rules for certain rental real estate activities.

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(f) Limited partnership interests in rental real estate activities -- (1) In general.

If a taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as an interest in a limited partnership as a limited partner (within the meaning of § 1.469-5(e)(3)), the combined rental real estate activity of the taxpayer will be treated as an interest in a limited partnership as a limited partner for purposes of determining material participation. Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in § 1.469-5(e)(2) (dealing with the tests for determining the material participation of a limited partner).

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Steven T. Miller
Deputy Commissioner for Services
and Enforcement.

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