INCONSISTENCY AND UNCERTAINTY: THE PROBLEM OF APPLYING PARTNERSHIP TAXATION TO LIMITED LIABILITY COMPANIES

I. INTRODUCTION

The birth of the limited liability company (LLC) sparked a revolution in business formation.[1] In just a few short decades, the LLC has become the business entity of choice for millions of new American businesses.[2] The LLC's meteoric rise in popularity appears to be more than a passing fad since "there is no other alternative entity on the horizon" that so effectively delivers the combination of limited liability, pass-through taxation, and flexibility of contract.[3] The popularity, however, has been mostly practitioner-driven, and scholars and commentators have not provided cutting edge leadership in a rigorous debate of LLC legal issues.[4] As a result, legal issues involving LLCs are now entering the court system with sparse reference material for judges. One such issue is the nature of LLC interests. The LLC is not a corporation and is not a partnership. Nevertheless, current tax regulations require that the LLC entity choose to be taxed as one of these other entities, and the majority of LLCs are taxed as partnerships. The Court of Federal Claims faced as a matter of first impression the question of whether an LLC member was

---

1 Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 459 (2010).

2 *Id.* at 460. Professor Chrisman notes that over 1.3 million LLCs were formed in 2007 alone, nearly double the number of corporations formed in the same year. *Id.* at 460 n.2.

3 *Id.*

4 *Id.* at 463 ("Law schools, law professors, law publishers, bar examiners and others usually responsible for disseminating cutting edge developments have been surprisingly absent from the playing field most of the time.") (citation omitted). Professor Chrisman notes that most casebooks for business organizations law courses have more pages devoted to limited partnerships than to limited liability companies, even though LLC formation outpaced LP formation by 34 to 1 in 2007. *Id.* at 462–63.

to be taxed as a general or limited partner.[5] The challenge for courts is that an LLC member is not a partner at all, and the LLC interest has characteristics of both a general and a limited partnership interest.

Part II *infra* reviews the birth and expansion of the LLC. Proponents of the LLC organizational form were pressing for a golden mix of limited liability, like a corporation possesses, and pass-through taxation, like a partnership possesses. Proponents achieved their goal when the Internal Revenue Service (IRS) adopted "check-the-box" regulations in 1997. Taxation of LLCs as partnerships, however, results in analysis problems for courts because of the obvious fact that LLCs are *not* partnerships. Part III *infra* discusses cases of first impression that have recently been decided by courts struggling to characterize an LLC interest. Part IV suggests that LLCs need a separate tax treatment because they are unique entities.

II. THE SEARCH FOR THE GOLDEN MIX OF LIMITED LIABILITY AND PASS-THROUGH TAXATION

Corporation shareholders enjoy limited liability, but the corporation is taxed as an entity before distributing profits, which are taxed again at the shareholder level—double taxation. Partnerships are not taxable entities, thus avoiding the double taxation, but partners are subject to liability for the debts of the partnership. Creative entrepreneurs sought a golden mix—the limited liability of the corporation and the pass-through taxation of the partnership.

A. Wyoming Starts a Quiet Revolution.

Congress attempted to create the golden mix by enacting Subchapter S of the Internal Revenue Code (the Code)[6] in 1953. Subchapter S blends partnership and corporate tax attributes

5 *See infra* Part III.B.1 (discussing Thompson v. United States, 87 Fed. Cl. 728, 730 (Fed. Cl. 2009)).

6 I.R.C. §§ 1361-79 (2007).

to encourage the formation of small businesses.[7] Until Subchapter S was reformed in 1982, the complexity caused by its hybrid form of taxation resulted in taxpayers suffering adverse tax consequences because they lacked sufficient knowledge of the technical Code provisions.[8] Taxing a corporation like a partnership "harbored traps for the unwary [and] unintended benefits to the enlightened taxpayers."[9] The 1982 Subchapter S reforms had not yet been enacted when an independent oil explorer, Hamilton Brothers Oil Company (Hamilton Brothers), sought a business form that would provide limited liability to the owners and partnership tax treatment to the entity.[10]

Hamilton Brothers was familiar with foreign business entities, such as the Panamanian "*limitada*" that are taxed in the United States as partnerships even though they possess limited liability for owners.[11] Hamilton Brothers first approached the Alaska Legislature, lobbying for a statute that would authorize the creation of an entity form like the foreign *limitada.*[12] The bill was not enacted because the Legislature feared that the entity would be taxed as a corporation.[13] Hamilton Brothers then approached a more adventuresome Wyoming Legislature. In 1977,

---

7 Deborah Pitman Austin, *Subchapter S Revision Act of 1982: Looking Beyond*, 32 EMORY L.J. 821, 825 (1983).

8 *Id*. at 825. Examples of reform contained in the 1982 overhaul included increasing the number of permitted shareholders to thirty-five, loosening the "one class of stock" rule to allow differences in voting rights, and eliminating the passive income restrictions for S-corporations that had never been C-corporations. *Id.* at 829, 833. In addition, the reform greatly reduced the complexity of the rules regarding allocations and distributions, making them more like partnerships. *Id.* at 845–854.

9 *Id*. (noting traps such as complicated distribution rules and benefits such as retroactive termination).

10 19 TEX. PRAC., BUSINESS ORGANIZATIONS § 18:2 (3d ed.).

11 Carter G. Bishopdl, *Reverse Piercing: A Single Member LLC Paradox*, 54 S.D. L. Rev. 199, 203 n.7 (2009); Joseph A. Rodriquez, Comment, *Wyoming Limited Liability Companies: Limited Liability and Taxation Concerns in Other Jurisdictions*, 27 LAND & WATER L. REV. 539, 542 (1992).

12 Rodriguez, *supra* note 11, at 544.

13 *Id*.

Wyoming enacted the first LLC statute in the nation.[14] Wyoming immediately requested a ruling from the IRS regarding tax classification. In essence, Wyoming was asking that its new business form be taxed as a partnership even though it was clearly not a partnership. Wyoming spurned the as-yet-unreformed Subchapter S regulations, instead seeking partnership taxation. The confusion resulting from taxing an entity as something it is not became immediately apparent.

B. The IRS Sends Mixed Signals

In 1980, within the space of forty-eight hours, the IRS issued a ruling and proposed regulations that contradicted each other.[15] The proposed regulations explicitly provided that if no member of an unincorporated association, like an LLC, was personally liable for the debts of the organization, then it would be taxed as a corporation.[16] Corporate liability thus became the primary characteristic by which an entity was judged for tax purposes. In such a case, a limited liability company could never be taxed as a partnership. Nevertheless, the next day, the IRS ruled that a Wyoming LLC would be "classified as a partnership, rather than a corporation, for federal tax purposes."[17] This was true even though a Wyoming LLC had no member that was personally liable for the debts of the entity. Two years later, the IRS confirmed corporate taxation by issuing a Private Letter Ruling concluding that an LLC was taxable as a corporation.[18]

---

14 Bishopdl, *supra* note 11, at 204.

15 *Id*.

16 *Id*. (citing 48 Fed. Reg. 75710 (Nov. 17, 1980)).

17 *Id*.

18 I.R.S. P.L.R. 8304138 (Oct. 29, 1982). The IRS noted that an association would be taxed as a corporation if it exhibits continuity of life, centralization of management, limited liability, and transferability of interests. Although applicable state law and the provisions of the operating agreement under review indicated limited life, the IRS assigned continuity of life based on a provision in the operating agreement that required member pre-approval before dissolution. Centralized management and limited liability were obvious. With three of the four corporate characteristics shown, the IRS categorized the limited liability company as a corporation. *Id.*

The unpopular proposed regulations were withdrawn in 1983,[19] leaving the tax characterization of LLCs to be determined by the presence or absence of four characteristics: continuity of life, centralization of management, limited liability, and free transferability of interests.[20] An entity that possessed no more than two of the four characteristics would be taxed as a partnership. In 1988, the IRS issued a ruling that gave Wyoming LLCs "bullet-proof" status because the state statutes sufficiently pre-empted an LLC from possessing too many of the corporate characteristics.[21] In contrast, Florida's LLC Act allowed its LLCs to negate automatic dissolution if such a provision was placed in the articles of organization, thus giving the entity potential continuity of life.[22] As a result, each Florida LLC could gain partnership taxation only by showing that the offending provision was not in its articles of organization.[23] Between 1980 and 1997, an LLC's tax characterization was based on which non-LLC entity form the LLC most resembled: the partnership or the corporation.

Legislatures raced to enact Limited Liability Company Acts. Each state modeled its statutes on either Wyoming or Florida, but each state also submitted "requests for rulings regarding the tax classification of a limited liability company formed under its state laws."[24] The avalanche of requests and the uncertainty experienced by taxpayers caused the IRS to take a different approach. Rather than determining an LLC's tax status by how well the members shoe-horned the LLC into the characteristics of another entity, the "check-the-box" regulations adopted in 1997 allowed an LLC to simply choose to be treated as a partnership or corporation

---

19 Bishopdl, *supra* note 11, at 206.
20 *Id*. Two additional characteristics—associates and an objective to carry on a business—were common to both partnerships and corporations and were thus ignored. *Id.*
21 *Id*. at 207 (citing Revenue Ruling 88-76).
22 *Id*.
23 *Id*.
24 *Id*.

regardless of the LLC's characteristics.[25] Proponents of the LLC achieved the golden mix: an entity that provides partnership taxation with a liability shield for all owners. Nevertheless, the stubborn fact remains that an LLC is not a partnership and is not a corporation. Treating it as such for the purposes of taxation causes legal inconsistency and uncertainty.

C. "The New King of the Hill"

After the IRS adopted "check-the-box," the seeming predictability and flexibility of LLC taxation led to a further explosion of popularity. Today the LLC is the most popular entity form for new businesses. From 2004 through 2007, nearly 5 million domestic LLCs were formed in the United States, over 1.5 million more than domestic corporations for the same period.[26] LLCs have been marketed to individuals as a tool for such diverse goals as estate planning[27] and small businesses.[28] LLCs have been portrayed as a fast and easy way to provide liability protection for the average taxpayer's assets. These taxpayers may create an LLC simply by filling out an online form with the appropriate government official and paying the fee.[29] Undoubtedly, many taxpayers do not understand the complexity of the partnership tax scheme into which they fall by

---

[25] Steven C. Alberty, *What You Should Know About the Taxation of Limited Liability Companies: LLCs Are Very Flexible and Seemingly Simple; There Are, However, Some Tricky Tax Issues.*, Prac. Tax Law., Winter 2004, at 45, 46. As a default, an LLC is taxed as disregarded entities if it has one member and as a partnership if it has more than one member.

[26] Chrisman, *supra* note 1, at 475, 479.

[27] *See, e.g., Use of Limited Liability Companies in Estate Planning*, April 21, 2011, http://www.wardandsmith.com/articles/use-of-limited-liability-companies-in-estate-planning.

[28] *See, e.g., LLC Basics*, ENTREPRENEUR, June 1, 2005 (available at http://www.entrepreneur.com/article/77966) (focusing especially on those businesses that "don't expect to expand or have significant revenue").

[29] See, for example, the online registration option for Washington State limited liability companies at http://sos.wa.gov/corps/LimitedLiabilityCompaniesLLCOnlineandPaperRegistrations.aspx. See also a "self-help" legal service that offers "basic" LLC creation packages for $99 at http://www.legalzoom.com/llc-guide/llc-taxes.html.

default[30]— a scheme that has been described as "the most complicated system of taxation ever devised by man."[31]

In addition, taxpayers can be lured into complicated schemes that purport to use LLCs to reduce taxes. Dr. Robucci was one such unfortunate taxpayer. Dr. Robucci contacted Mark Carson, a licensed attorney and certified public accountant who specialized in "choice-of entity planning," boasting roughly "3,500 clients, mostly small businesses."[32] Mr. Carson persuaded Dr. Robucci to adopt an organizational plan whereby an LLC would conduct his practice and a separate corporation would be formed as a business management corporation.[33] Because the LLC needed two members, a second corporation was formed, which owned a 5% stake in the LLC.[34] Dr. Robucci owned 100% of the corporations and 95% of the LLC, with the other 5% being owned through the second corporation. Mr. Carson did not explain to Dr. Robucci why he needed three entities.[35] Dr. Robucci attempted to use the entities to divide his income between "passive" and "non-passive" sources and to avoid paying self-employment tax on the "passive" amount. The IRS challenged the arrangement and the Tax Court found for the IRS.[36]

---

30 Additionally, most members of "do-it-yourself" LLCs, are likely to be completely unaware of the impact organizational form can have in *non-tax* areas. *See, e.g.*, Trongone v. Bd. of Review, Dep't of Labor, A-6135-10T4, 2012 WL 2094079 (N.J. Super. Ct. App. Div. June 12, 2012) (holding that LLC members are "self-employed" and thus do not qualify for unemployment compensation even if the member worked as an "employee" for the LLC); Varney v. Astrue, CIV. 09-3105-KI, 2011 WL 1527362 (D. Or. Apr. 20, 2011) (holding that a minority owner's distributive share of an LLC can qualify as self-employment income for the purposes of determining eligibility for Social Security disability payments).

31 Chrisman, *supra* note 1, at 488.

32 Robucci v. Comm'r, 101 T.C.M. (CCH) 1060 (T.C. 2011).

33 *Id*. at *2.

34 *Id*. Dr. Robucci's organizational structure is summarized and simplified here. For a detailed description of the relationship of the three entities, and subsequent executed agreements, see *id*. at *2–3.

35 *Id*.

36 *Id*. at *9.

The court noted that “Dr. Robucci had a limited understanding of the need for the entities formed and the agreements and other documents drafted by Mr. Carson. He relied on Mr. Carson's representations that the actions taken would legitimately result in the tax minimization that he sought.”[37] Because Dr. Robucci did not fully understand the purpose and requirements of each business entity, he did not treat the entities as substantive businesses. The entities had no separate phone numbers, addresses, customers, or offices.[38] Thus, the court found no business purpose for the entities and found that they “were, essentially, hollow corporate shells.”[39] In upholding the penalties against Dr. Robucci, the court noted that “had [the organizational plan] been more carefully implemented, [the self-employment tax savings] well might have been realized, at least in part.”[40] But the court chastised Dr. Robucci “even though he was not a tax professional” because he “failed to exercise the ordinary business care and prudence required of him” by “question[ing] the efficacy of the arrangement that purported to minimize his taxes while effecting virtually no change in the conduct of his medical practice.”[41] Dr. Robucci’s foray into the “choice-of-entity” arena cost him over $13,000 in penalties.[42]

Less than twenty years have passed since the IRS promulgated the “check-the-box” regulations and transferred to the taxpayer the burden of choosing the appropriate tax characterization. This flexibility creates a situation in which two identical LLCs may be taxed differently based on which tax election the taxpayer makes. The explosion in the popularity of LLCs, the intricacies of the Tax Code, and the lack of tax savvy on the part of many LLC owners

---

37 *Id*. at *3.
38 *Id*. at *4.
39 *Id*. at *8.
40 *Id*. at *10.
41 *Id*.
42 *Id*. at *1.

has set the stage for a barrage of tax issues to arrive on the dockets of the Court of Federal Claims and the Tax Court as matters of first impression.

III. FIRST IMPRESSIONS: THE COURTS STRUGGLE TO CHARACTERIZE LLC INTERESTS

The creation of a new business entity, the LLC, promised limited liability without the "double taxation" of the corporation. States granted the limited liability by creating a whole new type of entity. The legislators who created the new entity have usually failed, however, to create statutes to deal with LLCs as the unique entity form that they are. Similarly, Congress has failed to address in the Tax Code the LLC's unique characteristics. "Statutes drafted prior to the advent of LLCs obviously were not drafted with LLCs in mind."[43] Because legislators have failed to act, courts must decide how to apply these statutes to LLCs. The rationales used by various courts across the nation in addressing LLC *non-tax* issues have been similar to the rationales used by the Court of Federal Claims and the Tax Court when addressing LLC tax issues.

A. Literal Interpretation or Analogy?

Faced with the challenge of applying to LLCs statutes drafted for other entity forms, courts have approached the legal issues in various ways. Some courts read the statute literally and decline to apply a statute to LLCs unless the statute has been revised to include LLCs. Other courts analogize between the statute and the LLC to see if the two "fit." For example, in 2006, the Mississippi Supreme Court reversed a lower court ruling and refused to apply to LLCs an embezzlement statute requiring that the entity be "incorporated."[44] The appeals court had reasoned that interpreting the statute literally would allow members to embezzle from their LLCs

---

43 Elizabeth S. Miller, *Developing a Unique Theory of Limited Liability Companies or Simply Borrowing from Other Forms?*, 42 SUFFOLK U.L. REV. 617, 626 (2009).

44 *Id*. at 626 (citing Champluvier v. State, 942 So.2d 145 (2006)).

without legal consequence.[45] Nevertheless, the Mississippi Supreme Court held that the literal interpretation of the unambiguous term "incorporated entity" must prevail because the Mississippi Legislature had failed to amend the statute to include LLCs.[46]

In contrast, in 2008, the United States District Court of Nevada addressed as a matter of first impression whether an LLC "should be treated as a corporation or a partnership for the purposes of the attorney-client privilege."[47] Rather than applying federal common law to LLCs as a separate and distinct entity form, the court reasoned by analogy to determine which other entity more closely fit the LLC structure. The court concluded that the LLC more closely resembled a corporation and applied the attorney-client privilege to the LLC as if it were a corporation.[48]

In addition to determining the nature of the LLC, courts have been required to determine the nature of the LLC member's interest. Some courts have rejected a literal, mechanical application of a statute and have, instead, scrutinized the LLC's operating documents and the actual operation of the LLC. The Second Circuit Court of Appeals held that even though an LLC's organizational documents granted members extensive operation and management powers, the lack of actual participation by the members supported a finding of a "security" under the *Howey* test.[49] The court noted that "because of the sheer diversity of LLCs, membership interests therein resist categorical classification[, requiring a] case-by-case analysis into the economic realities of the underlying transaction."[50] Applying the same scrutiny of organizational

---

45 *Id*.
46 *Id*.
47 Montgomery v. eTreppid Technologies, LLC, 548 F.Supp.2d 1175, 1179 (1980).
48 *Id*. at 1187.
49 Miller, *supra* note 43, at 622–23 (discussing United States v. Leonard, 529 F.3d 83, 89 (2d Cir. 2008)).
50 *Leonard*, 529 F.3d at 89.

documents and "economic reality," the Fourth Circuit Court of Appeals held that the LLC membership interest was not a security.[51] The court reasoned that "LLCs are particularly difficult to categorize . . . because they are hybrid business entities that combine corporations, general partnerships, and limited partnerships."[52] The court declined to distinguish based on whether the LLC was member-managed or manager-managed because the practical levels of management and control in a particular LLC might not match the form or label.[53]

The nature of the membership interest is at the heart of the challenge facing taxpayers and courts addressing tax issues. Congress, through the IRS, dealt with LLC taxation by forcing the LLC to be taxed as a business form that it was not: a partnership, a corporation, or a disregarded entity. As a result, the LLC has been forced into an ill-fitting tax structure that was designed for an entity with different characteristics. The consequences of this ill-fit are beginning to arrive on court dockets as issues of first impression. Like other courts, the Court of Federal Claims and the Tax Court have addressed tax issues using a combination of literal interpretation of the statutes, analogy to other entity forms, and scrutiny of the organizational documents and operational reality.

B. The Court of Federal Claim's First Impression on Passive Losses: Thompson v. United States

A large majority of multi-member LLC's are taxed as partnerships. When the "check-the-box" regulations arose, concern that an inadvertent check "could result in unintended but serious tax consequences" led to a default rule that, absent an affirmative election to be taxed as

---

51 Miller, *supra* note 43, at 624–25 (discussing Robinson v. Glynn, 349 F.3d 166 (4th Cir. 2003).

52 *Robinson*, 349 F.3d at 174.

53 *Id*.

something else, the multi-member LLC would be taxed as a partnership.[54] But the "check-the-box" election determines the tax classification of the *LLC* and says nothing about the classification of the *member-owner*.[55] Several sections in the Code require a determination of whether the taxpayer is a general or limited partner, including passive loss rules under § 469, self-employment taxation under § 1401, and the new healthcare surcharge under § 1411.

The Court of Federal Claims addressed this legal issue as a matter of first impression in *Thompson v. United States.*[56] The court noted that "LLCs are hybrid entities that under state law are neither partnerships nor corporations. Nevertheless, under the Treasury Regulations, an LLC must choose to be taxed as either one or the other."[57] The court was asked to decide whether a member's interest in an LLC "is a limited partnership interest for purposes of applying the passive activity rules of [Code] § 469."[58] The court methodically, and correctly, reasoned through the application of partnership regulations to a non-partnership entity. Due to the importance of this ruling, it is discussed here in detail. Related legal issues are discussed *infra* in Part III.C.

1. General or Limited Partnership Interest?

In March 2002, James Thompson formed a Texas LLC.[59] The LLC's articles of organization designated Thompson as the only manager of the LLC.[60] The LLC was taxed as a partnership by default because Thompson did not elect for the LLC to be taxed as a

---

54 Alberty, *supra* note 25, at 46.
55 *Id.*
56 Thompson v. United States, 87 Fed. Cl. 728, 730 (Fed. Cl. 2009) ("This is a question of first impression for the court.").
57 *Id.*
58 *Id.*
59 *Id.*
60 *Id.* at 731.

corporation.[61] Thompson claimed losses on his individual income tax returns of $1.2 million and $940,000 for years 2002 and 2003 respectively. The IRS auditor disallowed all the claimed losses and assessed additional tax liability and interest amounting to over $700,000 for the two years.

The parties stipulated that the outcome of the case would be determined by the characterization of Thompson's LLC interest.[62] If the interest was characterized as a general partnership interest for purposes of passive loss deduction, then Thompson would be allowed to claim the loss. If, however, the interest was characterized as a limited partnership, then the losses would be disallowed. The result followed from the different "material participation" tests for the two types of interests.

A taxpayer holding a general partnership interest materially participates "in an activity only if he is involved in the activity's operations on a regular, continuous, and substantial basis [and] an individual may establish his material participation for a given taxable year by demonstrating any of [seven criteria]."[63] In contrast, the Code presumes that a taxpayer holding a

---

61 *Id.*

62 *Id.* at 730. The stakes are high for the taxpayer. If the loss is classified as "passive" then it can be deducted only to the amount of passive income reported. In contrast, if the loss is "ordinary," rather than passive, then the taxpayer may use the loss to offset any other ordinary income, including wages. *Id.*; Gregg v. United States, 186 F.Supp.2d 1123 (Ore. 2000).

63 *Thompson*, 87 Fed. Cl. at 731 (internal citation omitted). The seven criteria are the following:

> (1) The individual participate[d] in the activity for more than 500 hours during such year;
>
> (2) The individual's participation in the activity for the taxable year constitute[d] substantially all of the participation in such activity of all individuals . . . for such year;
>
> (3) The individual participate[d] in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year [was] not less than the participation in the activity of any other individual . . . for such year;

limited partnership interest does not materially participate and allows the taxpayer to demonstrate material participation using only three of the seven tests available to the taxpayer with the general partnership interest.[64] Since both parties agreed that Thompson could prove material participation under the general partnership interest tests but not under the narrower limited partnership tests, the "case turn[ed] on the proper application of Treasury Regulation § 469–5T(e)(3) to [Thompson's LLC] interest."[65] Applying the regulation, the court held that Thompson's LLC interest was a general partnership interest, not a limited partnership interest.

---

(4) The activity [was] a significant participation activity . . . for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceed[ed] 500 hours;
(5) The individual materially participated in the activity . . . for any five taxable years . . . during the ten taxable years that immediately precede[d] 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 participate[d] in the activity on a regular, continuous, and substantial basis during such year.

Treas. Reg. § 1.469–5T(a). The court noted that this temporary regulation was issued on February 19, 1988 and remains in force today. *Thompson*, 87 Fed. Cl. at 731 n.6 (citing Garnett v. Comm'r of Internal Revenue, No. 132–19, 2009 WL 1883965, at *3 n. 11 (T.C. June 30, 2009)).

64 *Thompson*, 87 Fed. Cl. at 731. An individual with a limited partnership interest is deemed to have materially participated only if the individual can demonstrate that: the individual participated in the activity for more than 500 hours during such year; the individual materially participated in the activity for any five taxable years during the ten taxable years that immediately preceded the taxable year; or the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years preceding the taxable year. *See* Treas. Reg. § 1.469–5T(e)(2). Since the years in question were the first two years of operation for the LLC, the last two tests were not available to Thompson. Interestingly, the court in *Gregg v. United States* agreed with the IRS that the regulations do not provide for proration of the hour requirements in the case of entities formed late in the year, thereby effectively making the first test unavailable to taxpayers who form their entities too late in the year to participate the full 500 hours. Gregg v. United States, 186 F. Supp. 2d 1123, 1129 (Ore. 2000).

65 Thompson, 87 Fed. Cl. at 733.

2. “An LLC Is Not a Partnership.”

The court addressed, as a threshold matter, the obvious reality that “an LLC is not a partnership.”[66] Unlike partners in general partnerships, “LLC members may participate directly in the management of the company [and] all members enjoy limited liability regardless of their respective levels of involvement.”[67] In contrast, in order for partners in a partnership to enjoy limited liability, they must establish a *limited* partnership and “distinguish between (1) their limited partners, who have limited liability but are unable to participate in the management of the partnership; and (2) their general partners, who may participate in the management of the partnership but are personally liable for its debts.”[68] The court then began the process of applying regulations designed for partnerships to the non-partnership entity.

Since the IRS itself has not officially interpreted § 469 in the context of LLCs, the court looked to the text, structure, and purpose of the regulation to derive its plain meaning.[69] Treasury Regulation § 1.469–5T(e)(3) states that “a partnership interest shall be treated as a limited partnership interest if . . . [t]he 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.*”[70] The court reasoned that the regulation literally requires that the business entity be a partnership under state law and not merely be taxed as a partnership.[71] Further, the court noted that Code

---

66 *Id.* at 733. “LLCs are hybrid entities that under state law are neither partnerships nor corporations.” *Id.* at 729-30.
67 *Id.* at 733.
68 *Id.*
69 *Id.* at 734.
70 *Id.* (emphasis in original).
71 *Id.*

§ 469(h)(2) applies to a limited partnership interest held by a limited partner.[72] The court concluded that the section did not apply to Thompson, who was a member, not a limited partner, of an LLC, not a limited partnership. Based on a literal interpretation of the terms, the Code § 469(h)(2) presumption against material participation cannot be applied to LLCs.

The court observed that the regulation section upon which the IRS relied contains an exception. A limited partner's interest is not treated as a limited partnership interest if the partner was also a general partner for the entire taxable year.[73] Thus, even if the limited partnership interest restriction applied to Thompson, he could prove material participation under the broader tests if he was also a general partner during the entire year. The court rejected the IRS argument that "the legal fiction created by the Code—that an LLC electing partnership taxation is a limited partnership"— applies to § 1.469–5T(3)(3)(i) but not to § 1.469–5T(3)(3)(ii).[74]

3. Liability or Control?

The core question for the court was whether the distinguishing characteristic for determining general interests from limited ones is the limited liability or the exercise of control. The IRS argued that Thompson's interests had to be characterized as limited partnership interests because the interests enjoyed limited liability.[75] Thompson, on the other hand, argued that his managerial control of the LLC was more akin to general partnership interests. The court agreed with Thompson, noting that by the time Code § 469 was passed in 1986 it was well established

---

[72] *Id.*; *see* I.R.C. § 469(h)(2) ("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.").

[73] Treas. Reg. § 1.469–5T(e)(3)(ii).

[74] *Thompson*, 87 Fed. Cl. at 735. The court called the argument "entirely self-serving and inconsistent." *Id.*

[75] The IRS's view that limited liability was the most important characteristic was reminiscent of the Service's position before the "check-the-box" regulations. *See supra* notes 16–18 and accompanying text.

that the limited liability of a limited partner was predicated on the limited partner's lack of participation in and control of the business.[76] The court summarized:

> Stated another way, a limited partner's level of participation in the business dictated whether or not he enjoyed limited liability. But the converse is not true. Under the ULPA, a limited partner who "takes part in the control of the business" becomes "liable as a general partner" [and t]he same is true under the RULPA . . . ."[77]

The court observed that the very purpose of Code § 469 and its regulations is to define passive activity and material participation—terms that relate to the participation and control of a business entity, not the level of liability. "If Congress desired a test that turned on a taxpayer's level of liability, it surely would have included the word 'liability' somewhere in the statute."[78]

In summary, the court concluded that "the tax code and the applicable regulations literally cannot be read to transfigure plaintiff's member interest in his LLC into one of a limited partnership."[79] Further, "an LLC is not 'substantially equivalent' to a limited partnership [because], unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability."[80] In conclusion, "once Treasury Regulation § 1.469–5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC."[81]

4. *Thompson* Accords with the Holdings of Other Courts

The characterization of LLC members as general partners in the context of § 469 has been addressed by other courts, resulting in similar holdings. The United States District Court for

---

76 *Thompson*, 87 Fed. Cl. at 735 (citing Uniform Limited Partnership Act, drafted in 1916, and the Revised Uniform Limited Partnership Act, drafted in 1976).

77 *Id.* at 736.

78 *Id.*

79 *Id.* at 730.

80 *Id.* at 738.

81 *Id.*

Oregon considered the issue as a matter of first impression in *Gregg v. United States*,[82] where taxpayers sought a refund of taxes assessed because of the disallowance of losses from taxpayers' LLC.[83] The LLC provided health consultation services and the taxpayer worked forty hours a week for the LLC.[84] Nevertheless, the IRS re-characterized the loss as passive, disallowed it, and assessed a deficiency, penalty, and interest.[85]

The IRS argued that "for Section 469 purposes, all members of an LLC will be treated as limited partners of the LLC that is taxable as a partnership, because of their limited liabilities under Oregon law."[86] The court rejected the argument of the IRS and, significantly, agreed with the taxpayer that Treasury Regulation § 1.469–5T(e)(3)(i)(B) "is obsolete when applied to LLCs and their members, because the limited liability company statutes create *a new type of business entity* that is materially distinguishable from a limited partnership."[87] The court reasoned that if all LLC members are treated as limited partners because of their limited liability, then the entity fails to meet the requirements of a "limited partnership" because there is not at least one general partner.[88] Additionally, the court noted that Congress enacted the passive loss limitation to thwart "tax-shelter" investments where the investor did not participate in the partnership's business and yet was able to deduct the resulting losses.[89] The court concluded that "[t]he limited partnership test is not applicable to all LLC members, because LLCs are designed to permit active involvement by LLC members in the management of the business."[90]

---

82 Gregg v. United States, 186 F. Supp. 2d 1123, 1127 (D. Or. 2000).
83 *Id*. at 1125. Taxpayers were a husband and wife filing a joint return. *Id*.
84 *Id*.
85 *Id*. Altogether, the amounts assessed by the IRS totaled about $145,000. *Id*.
86 *Id.* at 1128.
87 *Id*. (emphasis added).
88 *Id*.
89 *Id*.
90 *Id*.

The IRS challenged the *Gregg* holding in *Garnett v. C.I.R.*, arguing that *Gregg* "was decided incorrectly."[91] The IRS argued, again, that the taxpayer's interests in various LLCs and limited liability partnerships (LLPs) were subject to the passive activity presumption applied to limited partnership interests under § 469(h)(2).[92] The Tax Court disagreed and held for the taxpayer but did so by side-stepping the main issue. It noted that when Congress passed § 469 in 1986, LLPs had not come into existence and only one state, Wyoming, had an LLC statute.[93] Thus, Congress did not intend to apply the regulation to those forms of business entity. The court left open the possibility that § 469(h)(2) could be applied to "substantially equivalent entities" such as LLCs, but noted that no regulation had yet explicitly so provided.[94]

The *Garnett* court correctly recognized the basic problem. The court acknowledged that membership interests in LLCs differ significantly from interests of both general partners and limited partners.[95] The court observed:

> The need to pigeonhole the ownership interests as either general partner interests or limited partner interests arises in the first instance from the fiction of treating an L.L.P. or an L.L.C. as a "limited partnership" under section 1.469–5T(e)(3)(i) . . . . Inasmuch as classifying an L.L.P. or L.L.C. interest as a limited partnership interest entails a departure from conventional concepts of limited partnerships, it similarly entails, we believe, a departure from conventional concepts of general partners and limited partners.[96]

The court concluded that *"absent explicit regulatory provision"* legislative purposes were best served by treating LLC members as general partners for purposes of § 469(h)(2).[97] Some courts

---

91 Garnett v. C.I.R., 132 T.C. 368, 374 (2009).
92 *Id*.
93 *Id*. at 374–75. In addition, neither LLPs nor LLCs were mentioned in the temporary regulations promulgated two years later. *Id*. at 375. Florida enacted its LLC Act in 1982. Therefore, there were two states with LLC statutes, not one.
94 *Id*. at 377.
95 *Id*. at 380.
96 *Id*. at 380–381.
97 *Id*. at 381 (emphasis added).

have scrutinized the actual workings of the entities,[98] and the IRS urged the *Garnett* court to do the same because the "partnership agreements [in *Garnett*] did not give petitioners the authority to take action on behalf of the partnerships as a general partner would."[99] But the court rejected the IRS's argument and held that factual inquiry should focus on material participation rather than the organizational documents of the entities.[100]

The IRS responded to *Garnett, Gregg,* and *Thompson* by issuing an Action on Decision (AOD) acquiescing in result only.[101] A spokesperson for the IRS stated that the AOD was "issued to get the word out that we're not going to be litigating these cases anymore."[102] The spokesperson noted that besides Code § 469, "the government has struggled . . . in other areas of the Code as well, like Sections 464 and 736 and the self-employment tax area."[103]

C. Self-employment Tax and the LLC Characterization Conundrum

The *Thompson* court applied principles of statutory construction in the context of Code § 469 because the regulations had failed to define "limited partner."[104] The court determined that the literal interpretation was unambiguous, requiring that a business entity be a partnership under state law and not merely be taxed as a partnership.[105] In contrast, in *Renkemeyer, Campbell & Weaver, LLP v. C.I.R*,[106] the Tax Court applied principles of statutory construction and looked to legislative intent, reasoning that the term "'limited partner' is a technical term which has become obscured over time because of the increasing complexity of partnerships and other flowthrough

98 *See supra* notes 48–52 and accompanying text.
99 *Garnett*, 132 T.C. at 379.
100 *Id*.
101 2010-14 I.R.B. 515 (April 5, 2010).
102 *IRS Acquiesces in Result Only in* Thompson *Case*, 2010 WL 2594406.
103 *Id*.
104 Thompson v. United States, 87 Fed. Cl. 728, 734 (Fed. Cl. 2009); *see* discussion *supra*, Part III.B.
105 *Thompson*, 87 Fed. Cl. at 734.
106 Renkemeyer, Campbell & Weaver, LLP v. C.I.R., 136 T.C. 137 (2011).

entities as well as the history of section 1402(a)(13)."[107] Although analysis of the term by the two courts is in the context of two different Code sections, the disparate treatment under the same accepted principles of statutory construction demonstrates the difficulty in applying partnership terminology to a non-partnership entity.

The distinction between general and limited partners is critical in determining the self-employment tax liability of taxpayers who hold interests in LLCs taxed as partnerships. But, unlike taxpayers fighting the disallowance of their passive activity losses, LLC members fighting against self-employment tax assessment are more likely to be arguing *against* recognition as general partners.

1. Mixed Signals, Again

Code § 1401 imposes a tax on self-employment income, which includes the distributive share of income from any trade or business carried on by a partnership.[108] Treasury Regulation § 1.1402(a)–2 distinguishes a partner's earnings from his distributive share, though requiring that both be included in self-employment earnings. "The net earnings from self-employment of an individual include, *in addition to the earnings from a trade or business carried on by him*, his distributive share of the income or loss . . . from any trade or business carried on by each partnership of which he is a member."[109] The Regulations further provide that the term "partnership" applies to any entity which is recognized for taxation as a partnership, including

107 *Id*. at 149–150.

108 *Id*. at 146 (citing Code § 1402(a)). The distributive share does not include tax items such as capital gains, which would tend to represent investment by the partnership rather than trade or business, because the distributive share is figured under 702(a)(8), which excludes tax items that must be separately stated. *Id*.

109 Treas. Reg. § 1.1402(a)–2(d).

"unincorporated organization[s]" such as LLCs.[110] In addition, the Regulations state that the "net earnings from self-employment of a partner include his distributive share of the income or loss . . . *irrespective of the nature of his membership*. Thus, in determining his net earnings from self-employment, *a limited or inactive partner includes his distributive share of such partnership income or loss*."[111]

In spite of the clear language that "a limited or inactive partner includes his distributive share of income" in figuring self-employment earnings, and without altering that regulation, Congress passed a new statute section in 1977, § 1402(a)(13), that excluded the distributive share of limited partners. Code § 1402(a)(13) provides an exclusion for "any item of income or loss of a limited partner, as such, other than guaranteed payments . . . for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services."[112] Thus, if an LLC member is deemed to be a "limited partner," then distributions are not subject to self-employment tax unless the member actually rendered services to the LLC. On the other hand, if an LLC member is deemed to be a general

---

[110] Treas. Reg. § 1.1402(a)–2(f). This section also states that "[a]n organization described in the preceding sentence shall be treated as a partnership for purposes of the tax on self-employment income *even though such organization has elected, pursuant to section 1361 and the regulations thereunder, to be taxed as a domestic corporation*." *Id.* (emphasis added). "In the case of a partner who is a member of a partnership with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702(a)(9), from the trade or business carried on by the partnership computed *without regard to the fact that the partnership has elected to be taxed as a domestic corporation*." Treas. Reg. § 1.1402(a)–2(g) (emphasis added). As a result, a taxpayer holding an interest in an LLC taxed under Subchapter S will have the same tax liability as a partnership on the entire distributive share even though a taxpayer holding an interest in a *corporation* taxed under Subchapter S will be taxed only on income from services rendered.

[111] Treas. Reg. § 1.1402(a)–2(g) (emphasis added).

[112] I.R.C. § 1402(a)(13). Section 1402(a)(13), like Regulation § 1.1402(a)–2 distinguishes a partner's earnings from services rendered from his distributive share. Unlike the Regulation section, however, the Code applies the tax only to "earned" income.

partner, then the distributive share of income is subject to self-employment tax regardless of the nature of the member's interest.

2. Congress Reacts to the IRS's Attempt to Define "Limited Partner"

When Congress passed § 1402, it failed to define "limited partner." To fill this gap, "the Secretary issued proposed regulations . . . . The proposed regulations ignited controversy."[113] Congress enacted legislation barring the Secretary's definition of "limited partner" from becoming effective.[114] Further, the Senate issued a Sense of the Senate resolution regarding the issue in which the Senate found:

> (4) certain types of entities, **such as limited liability companies** and limited liability partnerships, were not widely used at the time the present rule relating to limited partners was enacted, and that the proposed regulations attempt to address owners of such entities;
> (5) the Senate is concerned that the proposed change in the treatment of individuals who are limited partners under applicable State law **exceeds the regulatory authority of the Treasury Department and would effectively change the law administratively without congressional action**; and
> (6) the proposed regulations address and **raise significant policy issues** and the proposed definitions of a limited partner may **have a substantial impact on the tax liability of certain individuals and may also affect individuals' entitlement to social security benefits**.
>
> (b) Sense of Senate.—It is the sense of the Senate that—
> (1) the Department of the Treasury and the Internal Revenue Service **should withdraw Proposed Regulation 1.1402(a)–2 which imposes a tax on limited partners**; and
> (2) **Congress, not the Department of the Treasury or the Internal Revenue Service, should determine the tax law governing self-employment for limited partners**.[115]

---

113 Renkemeyer, Campbell & Weaver, LLP v. C.I.R., 136 T.C. 137, 148 (2011). The Secretary issued the proposed regulations in 1997, twenty years after § 1402(a)(13) was enacted. *Id*.

114 *Id*. (citing the Taxpayer Relief Act of 1997, Pub.L. 105–34, sec. 935, 111 Stat. 882 ("No temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.")).

115 *Id*. at 149 (quoting 143 Cong. Rec. 13297 (1997)).

Neither Congress nor the IRS has "issued any other pronouncements with respect to the definition of a limited partner for purposes of the self-employment tax."[116]

3. Legislative Intent

When Congress passed the exception to self-employment taxation in 1997, it did so to distinguish investment income from employment income.[117] Until enactment of the change, all partnership income was subject to the self-employment tax. In § 1402(a)(13), Congress distinguishes between income received by a general partner and income received by a limited partner and excludes from social security coverage the income received by a limited partner. Congress intended "*to exclude for coverage purposes certain earnings which are basically of an investment nature*."[118] Congress's motive was not necessarily to save the taxpayer from imposition of the tax, but rather to prevent those who were merely investors from claiming credits toward Social Security coverage.[119] This motive is reflected in the Senate's concern that the Secretary's proposed definition would affect Social Security benefits.[120] Congress's intent was to apply self-employment tax liability, and grant the accompanying Social Security credits, to partnership activities that were more akin to employment and less akin to passive investment. The use of LLCs for everything from small businesses to asset protection has created confusion as to how to apply partnership self-employment taxation to this non-partnership entity.

4. Characterizing LLC Interests for Self-Employment Tax Purposes

Perhaps it is not surprising that a taxpayer, who has formed an LLC with his wife to start a new business, would distinguish between income earned as wages and the rest of the LLC

---

116 *Id*.
117 *Id*. at 150.
118 *Id*. (quoting H. Rept. 95–702 (Part 1), at 11 (1977)) (emphasis added by Tax Court).
119 *Id*.
120 *See supra*, text accompanying note 114.

earnings. If the business entity formed were a corporation taxed under Subchapter S, such a view would be correct. Such a view appears to align with Congress's intention to exclude for purposes of self-employment income earnings that are "basically of an investment nature" and to impose the tax and grant accompanying Social Security credits on earnings from services rendered to the partnership. But such a view was flatly rejected by the Tax Court in *Riether v. United States.*[121]

Dr. and Mrs. Riether created an LLC, which was taxed as a partnership, for their diagnostic imaging business.[122] Their LLC issued W-2 statements to each of them for the amount designated as "wages" and listed the rest of their LLC's income on a K-1. The Riethers paid self-employment tax on the "wages" but not on the rest of the LLC's earnings, which they considered a return on investment.[123] In a scathing opinion, the Tax Court rejected the distinction, calling it "simplistic."[124] In response to the Riethers' claim that the amount on the K-1 was "'unearned income' [and therefore] not subject to the self-employment tax," the court responded that the "magic words 'unearned income' won't do the trick."[125] The court reasoned that the Riethers did not qualify for the self-employment exception because they were "not members of a limited partnership, nor do they resemble limited partners, which are those who 'lack management powers but enjoy immunity from liability for debts of the partnership.'"[126] The court concluded that all earnings of the LLC were subject to self-employment tax, irrespective of whether those earnings were active or passive.[127]

---

121 Riether v. United States, 10-CV-0622-BRB-LAM, 2012 WL 6934116 (D.N.M. June 21, 2012)
122 *Id*. at *17.
123 *Id*.
124 *Id*.
125 *Id*.
126 *Id*. at *18 (quoting Renkemeyer, Campbell & Weaver, LLP v. C.I.R, 136 T.C. 137, 147 (2011)).
127 *Id*.

In *Renkemeyer*,[128] the Tax Court distinguished between active and passive earnings. The attorney taxpayers in *Renkemeyer* formed a limited liability partnership for their law firm and stated in the partnership agreement that the partners' interests were "designated as limited partnership interests."[129] The attorneys argued that each partner's distributive share fell under the § 1402(h)(2) exception. The Tax Court disagreed.[130] Because the Code section does not define "limited partner," and the term "has become obscured over time because of the increasing complexity of partnerships and other flowthrough entities" the court applied "accepted principles of statutory construction to ascertain Congress's intent."[131] The court reasoned that Congress intended "to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations . . . would not receive credits toward Social Security coverage."[132] The court distinguished between income derived from legal services performed, which Congress intended to tax, and income that arises "as a return on the partners' investment," which Congress did not intend to tax.[133] The court concluded that since the payments were derived from services, the taxpayers did not qualify for the "limited partner" exclusion even though the interests were designated as "limited partnership interests."[134] Thus, unlike the *Riether* court that looked only to the technical meaning of "limited partner," the *Renkemeyer* court looked to the substance of the payments and legislative intent.

Undoubtedly, more cases involving characterization of LLC interests in the context of self-employment tax will be forthcoming. The Tax Court applied different reasoning in *Riether*

---

[128] *Renkemeyer*, 136 T.C. at 150.
[129] *Id*. at 147.
[130] *Id*.
[131] *Id*. at 149.
[132] *Id*. at 150.
[133] *Id*.
[134] *Id*. at 150.

and *Renkemeyer*, though arriving at the same conclusion—the taxpayer has to pay. The *Renkemeyer* court emphasized Congress's intent to tax only income that was more like wages and not to impose self-employment tax on income that was more like return on investment. Under that analysis, Dr. and Mrs. Riether had a credible argument. In *Robucci*, discussed *supra*, the court suggested that if the taxpayer had more carefully implemented the organizational plan, the earnings could have been split successfully between earned income, which was subject to self-employment tax, and unearned income, which was not.[135] Rather than reject the splitting of income into "earned" and "unearned," the *Robucci* court criticized the lack of written factual support for the percentage of income allocated to each category.[136] In the near future, the Court of Federal Claims will likely be called upon to provide a reasoned analysis of the characterization of LLC interests in the context of self-employment tax.

D. A New Medicare Tax

A new tax enacted under the Health Care and Education Reconciliation Act of 2010 will also require a determination of the characterization of an LLC member's interest. Code § 1411(a)(1) mandates a new 3.8% Medicare tax on "net investment income."[137] "Net investment income" includes passive activities within the meaning of Code § 469, but does not include any income which is subject to self-employment tax.[138] Thus the Medicare tax determination for LLC members will fall squarely between the characterization of membership interests for the purposes

---

135 Robucci v. Comm'r, 101 T.C.M. (CCH) 1060, *10 (T.C. 2011); *see supra* notes 31–41 and accompanying text.

136 *Robucci*, 101 T.C.M. 1060 at *2.

137 I.R.C. § 1411(a)(1). The tax is applied to gross income over the threshold amount. Currently, the threshold amount is $250,000 for married taxpayers filing jointly, $125,000 for married filing separately, and $200,000 in any other case.

138 *Id*. at (c)(2),(6).

of passive loss, as in *Thompson, Gregg,* and *Garnett*, and the characterization of membership interests for the purposes of self-employment tax, as in *Riether*, and *Renkemeyer*.

The application of the Medicare tax to LLC members has not yet been tested in the courts. The outcome of such litigation is uncertain. Neither the Code nor current jurisprudence has established a framework under which these questions can be resolved with consistency. The outcome will be determined by whether the court applies a literal interpretation of statutes, looks to legislative intent, or looks to the entity's operation and documents.[139]

IV. IT IS TIME TO TREAT THE LLC AS THE UNIQUE BUSINESS ENTITY THAT IT IS

The *Garnett* court identified the problem—"the need to pigeonhole the ownership interests [of LLCs] as either general partner interests or limited partner interests arises in the first instance from the fiction of treating" LLC interests as limited or general partnership interests, which necessitates a departure from the conventional meaning of those words.[140] The court concluded that "no regulation had yet explicitly" provided direction for the court and "absent explicit regulatory provision," the court had to decide as best it could.[141] Certainly, it is not the judiciary's role to make the weighty policy decisions necessary to implement this "fiction." But neither is it the role of the Executive Branch. The Service's attempt to fill the gap left by

[139] For example, where a member of a member-managed LLC has the authority of an agent of the LLC but exerts no actual control or management, the court might find the member to be a "general partner" for self-employment tax purposes based on the *Thompson* court's literal reading of the "limited partner" exemption and the *Riether* court's application of the tax to both active and passive income. But the court might also find that the member failed the material participation test and did not render services to the LLC, thereby being subject to the Medicare tax on passive income. To which tax the taxpayer is subject, thus depends on the framework applied by the court.

[140] Garnett v. C.I.R., 132 T.C. 368, 381 (2009).

[141] *Id.*

Congress was greeted with controversy and a sharp response from the Senate.[142] The Senate declared that "Congress, not the Department of Treasury or the Internal Revenue Service should determine the tax law governing self-employment for limited partners," and presumably similar issues as well.[143]

The Senate was correct. Congress must address the tax treatment of LLCs. It is the Legislature's job to weigh and balance diverse policy concerns. The policy issues intertwined in the taxation of LLCs are complex. LLCs are the primary vehicle for the start of small and family-held businesses. To the extent that Congress wants to encourage business development, it will need to provide a simple and comprehensible taxation system that does not pose traps for the unwary. Congress must decide if it wishes to tax all revenue from an LLC as self-employment income, giving Social Security credits for the full amount, or tax only those activities that render service to the LLC. With Congress's thirst for tax revenue but fear of Social Security insolvency, the decision on what to tax is more of a policy decision than a logical or moral decision. Further, millions of LLCs are formed each year. The owners of these LLCs have the potential to provide job growth and stimulate the economy. However, these owners are also constituents who will look unkindly on tax policies that penalize them for starting a new business or for failing to navigate the "the most complicated system of taxation ever devised by man."[144]

The LLC is a business form that is separate and different from a corporation or a partnership. LLCs are often described as "hybrids," and viewed as a "little brother" to the partnership and corporation.[145] But it is the hybrid nature that makes the LLC incompatible with either taxing system. As Professor Chrisman observed, "Little brother has grown up" and should

---

[142] *Renkemeyer*, 136 T.C. at 148; *see supra* Part III.C.2.
[143] *Renkemeyer*, 136 T.C. at 149 (quoting 143 Cong. Rec. 13297 (1997)).
[144] Chrisman, *supra* note 1, at 488.
[145] *Id*. at 463.

be given the attention it deserves.[146] With millions of LLCs being organized each year, it is time for Congress to take a comprehensive view of LLC taxation with Code sections addressed specifically to the unique character of LLC interests.

A. Starting with Subchapter S, But Not Ending There

Congress recognized long ago that closely-held companies and small businesses should have a simplified, pass-through taxation scheme. That was the impetus behind Subchapter S. Unfortunately, the original rules for Subchapter S were so complex that the creators of LLCs spurned Subchapter S for partnership taxation.[147] Had the reformed Subchapter S rules enacted in 1982 been in effect when LLCs were first formed, the battle for partnership taxation might have been avoided. Indeed, the number of LLCs choosing to be taxed as Subchapter S corporations has exploded.[148] However, the reformed version of Subchapter S was not available, and proponents of LLCs fought for partnership taxation. Arguably, the first LLC proponents were tax savvy companies like Hamilton Brothers.[149] But by the time the IRS adopted the "check-the-box" regulations, LLCs were being used by less savvy entrepreneurs. This is seen in the concern that a taxpayer would inadvertently mark the wrong box and wind up with "unintended but serious tax consequences."[150] The IRS's solution was to make partnership taxation the default, requiring an affirmative election to be taxed as a corporation.[151] The uninformed will thus fall by default into the complicated tax scheme of Subchapter K. Subchapter S, not Subchapter K, should be the starting place for LLC taxation.

---

146 *Id*.
147 *See supra* Part II.A.
148 Chrisman, *supra* note 1, at 487 (noting an increase of 524% in LLCs choosing to be taxed under Subchapter S in 2006 over 2002).
149 *See* discussion *supra* Part II.A.
150 Alberty, *supra* note 25, at 46.
151 *Id*.

Merely applying Subchapter S taxation to LLCs, however, will not solve the problem because an LLC is no more a corporation than it is partnership. A key characteristic of corporations is centralized control. A shareholder's control consists almost exclusively in the ability to vote for officers, who are agents of the company. In contrast, every member of a member-managed LLC has agency power to manage and control the company. This ability to participate in the company's management, and the question of whether the power is actually exercised, is at the heart of interpreting regulations regarding passive losses, self-employment tax, and the new Medicare tax.

Further, when Congress implemented Subchapter S, it complicated the tax scheme by importing pieces of Subchapter K into Subchapter S. For example, S-corporations are treated as partnerships for the purposes of Code provisions related to fringe benefits.[152] Similarly, regulations currently require that LLC members be taxed on self-employment income like partnerships even if the LLC has chosen to be taxed as a Subchapter S corporation.[153]

Congress should begin with the policies of Subchapter S, but create a taxation scheme specifically designed for LLCs. This will include characterizing the LLC membership interest for purposes of passive loss rules, self-employment tax, and the Medicare tax. To the extent that LLC taxation uses statutes and regulations with partnership or corporation terms—like "shareholder" and "limited partner"—Congress must define the term in the context of the LLC interest. In addition, Congress must address whether the form or the reality of the interest will prevail. For example, although a member of a member-managed LLC technically has management and control authority, the reality of the LLC's operations may negate any actual

---

[152] *See* 2008 I.R.B. 251, Special Rules For Health Insurance Costs of 2%-Shareholder Employees.

[153] *See* Treas. Reg. 1.1402(a)–2(f).

management or control. In such a case, will the member be presumed to be active, and thus subject to self-employment tax, or passive, and thus subject to the Medicare tax? Another policy issue is whether a member's role and authority can change from year to year. For example, can a taxpayer claim to be a passive member during years with net income but an active member in years with a net loss?

B. Distinguishing Between Small and Large Businesses

Congress should continue to distinguish between small and large companies. Subchapter S election is available only to companies that have less than a maximum number of shareholders.[154] Subchapter K also allows an election for certain partnerships, but at the other end of the spectrum. Partnerships can avoid some of the more arduous details of partnership taxation by electing to be treated as a "large partnership," defined as having 100 or more partners.[155] Further, smaller businesses that, among other things, have less than $5,000 in expenses and no employees, may use a Schedule C-EZ to file their taxes, while larger businesses must file the more detailed Schedule C.[156] Congress could likewise distinguish closely held and small business LLCs from others. This distinction could be made by number of members, value of assets, gross revenue, number of non-owner employees, or any other relevant criteria.

C. Filling the Leadership Gap

The Senate correctly stated that it is the role of Congress to address the taxation of LLCs. But as the *Garnett* court correctly noted, Congress has failed to act.[157] In the void, the IRS has taken some steps to fill the gap. In spite of the Senate's criticism of the IRS's proposed

---

[154] I.R.C. § 1361(b).
[155] I.R.C. § 775(a)(1)(A).
[156] IRS Form 1040 (Schedule C-EZ) (2012), available at http://www.irs.gov/pub/irs-pdf/f1040sce.pdf.
[157] Garnett v. C.I.R., 132 T.C. 368, 381 (2009).

regulations defining "limited partner" in the context of self-employment tax, the IRS's Temporary Regulations defining "limited partner" in the context of passive losses are still being used today.[158] The *Garnett* court suggested that the material participation limitation on "limited partners," which the court ruled did not apply to LLCs because they are not literally partnerships, could be applied to "substantially equivalent entities" such as LLCs if the IRS explicitly provided so in its regulations.[159] Thus far, the IRS has declined to do so. Arguably, such a substantive change is outside the scope of the IRS's power and should be made only by Congress.[160] However, in the absence of guidance from either Congress or the IRS, the courts are left to fill the gap.

There is no simple guideline for the Court of Federal Claims and the Tax Court to follow when applying partnership taxation to non-partnership entities. The *Thompson* court correctly and prudently interpreted the statutes and regulations literally and refused to apply the term "limited partner" to the LLC member.[161] In contrast, the *Renkemeyer* court found the term "limited partner" ambiguous and looked to legislative intent rather than literal interpretation.[162] Some courts reason by analogy, looking to see whether the entity more closely resembles a partnership or corporation.[163] And some courts recognize the "sheer diversity of LLCs" and look

[158] *See* Treas. Reg. § 1.469–5T(e)(3)(i).

[159] *Garnett*, 132 T.C. at 381. *But see* Thompson v. United States, 87 Fed. Cl. 728, 738 (Fed. Cl. 2009) (concluding that LLCs are *not* substantially equivalent to limited partnerships).

[160] Renkemeyer, Campbell & Weaver, LLP v. C.I.R., 136 T.C. 137, 148 (2011) (quoting 143 Cong. Rec. 13297 (1997) ("Congress, not the Department of the Treasury or the Internal Revenue Service, should determine the tax law governing self-employment for limited partners.")).

[161] *Thompson*, 87 Fed. Cl. at 730 (finding that the LLC member was not a "limited partner" under the literal interpretation of the term).

[162] *Renkemeyer*, 136 T.C. at 149.

[163] Montgomery v. eTreppid Technologies, LLC, 548 F.Supp.2d 1175, 1179 (1980) (framing the issue in terms of whether the LLC was more like a partnership or more like a corporation).

to the organizational documents and actual workings of the individual LLC.[164] Until Congress or the IRS acts, courts will have to determine the best mode of analysis on a case-by-case basis.

V. CONCLUSION

Limited liability companies are widespread and commonplace. Every indication is that the proliferation of LLCs will continue. It is incumbent upon Congress to address the taxation of LLCs in a comprehensive and prudent manner. Until then, the Court of Federal Claims and the Tax Court will be forced to apply partnership taxation to non-partnership entities, resulting in inconsistency and uncertainty for the taxpayer.

[164] United States v. Leonard, 529 F.3d 83, 89 (2d Cir. 2008).