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From:
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To:
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Subject: Section 469 analysis

This responds to your question as to whether § 469(c)(3) applies to the facts of your case.

Section 469(c)(3)(A) of the Internal Revenue Code provides that the term "passive activity" shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest.

Section 1.469-1(e)(4)(iv) of the Income Tax Regulations provides that for purposes of § 469 and the regulations thereunder, the term "working interest" means a working or operating mineral interest in any tract or parcel of land (within the meaning of § 1.612-4(a)). Thus, the regulations under § 469 define working interest in oil or gas property, for purposes of § 469(c)(3), by reference to the depletion rules set forth in §§ 611-614 and the regulations thereunder.

In general, § 611 provides for a reasonable allowance for depletion in the case of mines, oil and gas wells, and other natural deposits. Section 614 defines the term "property," for purposes of computing the allowance for depletion, as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Section 1.614-1(a)(2) provides that the term "interest" means an economic interest in a mineral deposit. Mineral deposit is defined in § 1.611-1(d)(4) as referring to minerals in place. Section 1.611-1(d)(5) defines minerals to include ores of metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits. That section further states that "minerals" includes all of the minerals and other natural deposits subject to depletion.

Thus, the exception provided by § 469(c)(3) for any working interest in any oil or gas property is limited to a working interest in natural deposits of oil and gas. In contrast to a working interest in a natural deposit of oil and gas, the activity that has given rise to the losses at issue here is the production of fuel from a manmade, nonconventional source, a landfill. Landfill gas is derived from the biodegradation of municipal solid waste. Under § 45K, a credit is available for the production of "qualified fuels" attributable to the taxpayer. Under § 45K(c)(1), the term "qualified fuels" includes gas

produced from biomass. Biomass is defined in § 45K(c)(3) as "any organic material other than (A) oil and natural gas (or any product thereof), and coal (including lignite) or any product thereof." Thus, the activity giving rise to the losses at issue is defined in part by its being *other than* an activity involving oil and gas. Therefore, for purposes of § 469(c)(3), the production and sale of landfill gas does not constitute a working interest in oil and gas property.

In addition, for purposes of § 469(c)(3), the liability of the partners is limited in this case. Section 1.469-1T(e)(4)(v) provides that an entity limits the liability of the taxpayer with respect to the drilling or operation of a well pursuant to a working interest held through such entity if the taxpayer's interest in the entity is in the form of (1) A limited partnership interest in a partnership in which the taxpayer is not a general partner; (2) Stock in a corporation; or (3) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).

The relevant analysis in this case is whether an entity limits the liability of the general partners with respect to the purported working interest held through the entity. On the facts provided, the general partnership does not directly hold the purported working interest, but instead owns the interest through a series of limited liability companies and trusts. The general partnership does not have any direct interest in the activities involved here, i.e., the extraction of methane from landfills to be converted into energy. Because it appears that the general partnership holds its interest through various entities that limit liability under applicable state law, the general partnership's liability is limited with respect to such interest. As a result, none of the general partners are exposed to liability with respect to the interest even though they are general partners in the general partnership. Since the general partners have used lower tier entities to limit their liability, they do not hold the interest directly or indirectly in a way that does not limit their liability. Therefore, the § 469(c)(3) exception to passive activities does not apply, and the general provisions of § 469 may act to limit the partners' losses.

Further support for this analysis is provided by the Senate Committee on Finance, S. Rep. No. 99-313, at 744 (1986). Specifically, the Senate Report states:

> When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision.… The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form. The rule is applied by looking through tiered entities. For example, a general partner in a partnership that owns a limited partnership interest in a partnership that owns a working interest is not treated as owning a working interest. S. Rep. No. 99-313, at 744 (1986).

If you receive further information that shows a change in the facts, please resubmit the question for further reconsideration.