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IRS DISPUTES WHICH "LIMITED PARTNERS" ESCAPE SECA TAXES UNDER SECTION 1402

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This article, the second in the series examining self-employment taxes, the limited partner exception, and the IRS's current compliance campaign, analyzes the IRS's positions in administrative rulings and court cases involving Section 1402 and SECA taxes.

Introduction

Two foundations of a quality tax system are clarity and consistency. If key terms are ambiguous, or if the U.S. Internal Revenue Service ("IRS") insists on interpreting such terms incoherently, things can go wrong. This is precisely what has occurred in the context of "limited partners."

The term "limited partners" appears in *many* places throughout the Internal Revenue Code and corresponding regulations. Two examples are cases involving the passive activity loss-limitation rules under Section 469 and cases centered on whether amounts from partnerships are subject to self-employment taxes, also known as Self Employment Contributions Act ("SECA") taxes, under Section 1402. The IRS takes different positions when defining "limited partner" in these two areas.

When it comes to the passive activity loss-limitation rules in Section 469, the IRS lobbies for a loose definition of "limited partner," because the rules generally provide that a "limited partner" does not "materially participate" in the relevant activity. As a result, the IRS financially benefits from *including* as many taxpayers as possible in the "limited partner" category for purposes of Section 469.

On the other hand, in situations focused on whether SECA taxes apply to certain amounts from entities treated as partnerships, the IRS advocates for a tight definition of "limited partner." This is because Section 1402 indicates that the distributive share of income to a "limited partner" is not exposed to SECA taxes. Thus, the IRS has an economic incentive to *exclude* the greatest number of taxpayers possible from the "limited partner" category when coping with Section 1402.

This article, the second in the series, centers on the IRS's positions in administrative rulings and court cases involving Section 1402 and SECA taxes.[1] The Tax Court decided the seminal case in this area over a decade ago, but the issue has regained importance lately because the IRS launched a "Compliance Campaign," many tax disputes are now underway, and the Biden Administration has urged Congress to implement legislative changes.

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Overview of SECA Taxes

Amounts earned by taxpayers for working generally are subject to so-called "employment taxes."

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When dealing with "employees," they are comprised of several items, including, but not limited to, federal income taxes and Federal Insurance Contributions Act ("FICA") taxes, consisting of Social Security taxes and Medicare taxes. However, in situations involving sole proprietors, independent contractors, and partners, SECA taxes substitute FICA taxes.[2] For 2020, the SECA tax rate was 15.3% of "net earnings from self-employment," which could represent a big payment if a taxpayer is prospering.[3]

The term "net earnings from self-employment" generally means gross income derived by an individual from any trade or business carried on by such individual, minus certain business-related deductions, plus his distributive share of income from any partnership in which he is a partner.[4] A number of exceptions exist. Importantly for purposes of this article, Section 1402(a)(13) excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share of any income item to a "limited partner," as a limited partner, other than certain guaranteed payments.[5]

Explanation for the Ambiguity

We need to take a step back to understand how and why matters are in such disarray. The first article in this series supplied enormous detail about the guidance issued by the IRS over time in an effort to clarify the treatment of "limited partners" in the context of SECA taxes. For purposes of this article, though, readers simply need to know that things have essentially been at a standstill, or perhaps a standoff, for about four and one-half decades. The main events are described below.

Enactment and True Purpose of Section 1402(a)(13). The Social Security system was established in 1937. Originally, self-employed workers did not contribute to, and were not eligible to receive benefits from, the system. This changed in 1950, when Congress introduced the SECA tax.[6] Distributive shares to partners of *all* types were subject to SECA taxes initially.[7] However, in 1977, Congress introduced the exception from SECA taxes for "limited partners" in Section 1402(a)(13).[8] The law has not changed since then.

Understanding the reasons why Congress created Section 1402(a)(13) is pivotal. However, the courts have arguably overlooked and/or misconstrued parts of the legislative history. In particular, the IRS and many courts focus primarily, if not solely, on the following portion of the legislative history:

> Under present law, *each partner's share of partnership income* is includable in his net earnings from self-employment for Social Security purposes, *irrespective of the nature of his membership in the partnership.* The bill [introducing Section 1402(a)(13)] would exclude from Social Security coverage the distributive share of income or loss received by a *limited partner* from the trade or business of a limited partnership. *This is to exclude for [Social Security] coverage purposes certain earnings which are basically of an investment nature . . . .*[9]

In making arguments and determinations, the IRS and courts have essentially ignored other portions of the same legislative history that raise the notion of allocating income between SECA amounts and non-SECA amounts. The following excerpt from the main congressional report hints at this bifurcation of income:

> Distributive shares received as a general partner would continue to be covered [by SECA taxes]. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered [by SECA taxes].[10]

Finally, perhaps the most critical insight from Congress comes later in the same report. It clarifies the exact problem, the perceived abuse, which Congress endeavored to solve by enacting Section 1402(a)(13):

> Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for Social Security benefits. In these situations, the investor in the limited partnership performs no services for the partnership and the Social

[1] The other two articles in the series are as follows. Sheppard, "Analyzing the Long Journey to Chaos: SECA Taxes, Limited Partner Exception, and Effects of Government Inaction," 48 Corp. Tax'n No. 6 (Nov/Dec 2021); Sheppard, "Heads the IRS Wins, Tails the Taxpayers Lose: Analyzing Inconsistent Positions on the Meaning of 'Limited Partners'" 49 Corp. Tax'n No. 2 (forthcoming, 2022).

[2] Section 1401(a) and (b); Rev. Rul. 69-184 (explaining that "remuneration received by a partner from the partnerships is not 'wages' with respect to 'employment' and therefore not subject to" FICA, federal income tax withholding or other employment taxes).

[3] Section 1401(a) and (b).

[4] Section 1402(a).

[5] Section 1402(a)(13).

[6] Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax (Sept. 2012), page 1.

[7] TD 7333 (Dec. 19, 1974); Reg. 1.1402(a)-2(d).

[8] Social Security Amendments of 1977, P.L. 95-216, section 313(b).

[9] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), page 11 (emphasis added).

[10] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), page 40.

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> Security coverage which results is, in fact, based on income from an investment. This situation is, of course, inconsistent with the basic principle of the Social Security program that [Social Security] benefits are designed to partially replace lost earnings from work.
>
> These advertisements and solicitations are directed mainly toward public [i.e., government] employees whose employment is covered by public retirement systems and not by Social Security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive Social Security credit in a year) will eventually gain a high return on the Social Security contributions. Many of those who invest in limited partnerships will qualify for minimum [Social Security] benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under Social Security for many years with low earnings. The costs of paying these heavily weighted benefits to limited partners must, of course, be bourne by all persons covered by the Social Security program. The advertising [for the sale of limited partnership interests] injures the Social Security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under Social Security, as well as those people without work income, who would like to be able to become insured under the Social Security program but cannot afford to invest in limited partnerships.[11]

Section 1402(a)(13) excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share of any income item to a "limited partner," as a limited partner, other than certain guaranteed payments.

What was Congress saying, in plain English? A careful reading reveals that Congress was concerned that (i) unscrupulous persons were selling limited partner interests solely for purposes of allowing individuals who were otherwise ineligible for the Social Security program to gain access; (ii) based on the minimum contribution they made to the partnerships and the minimum distributive shares they received, the limited partners were not investing in the normal sense of the word, not risking money with hopes of getting passive income in return; (iii) the limited partners were not paying any significant SECA taxes given the minimum distributive shares they received; (iv) the purchasers of the limited partner interests would obtain unfairly large Social Security benefits, to the detriment of all workers financing the system; (v) many government workers were participating in this improper scheme; and (vi) allowing abuse of the Social Security would trigger public resentment and claims of unfairness.

To address the *very specific problem* related to exploitation of the Social Security program by a particular group of people, Congress implemented a *very broad solution*. Namely, Congress introduced Section 1402(a)(13), which excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share of any income item to a "limited partner," as a limited partner, other than certain guaranteed payments.[12]

Proposed Regulations. After chewing on the matter for about two decades, the IRS issued its first set of proposed regulations about Section 1402(a)(13) in 1994.[13] They contained rules related to the treatment of limited partners in partnerships, as well as members of limited liability companies ("LLCs") treated as partnerships, with respect to SECA taxes.[14]

After reviewing written comments from the public and holding a hearing, the IRS decided to revamp its approach. In 1997, it withdrew the first proposed regulations and released a second set. This time, the IRS provided proposed guidance covering *all* entities classified as partnerships for federal tax purposes, not just LLCs. The updated rules arguably would cover limited partnerships, LLCs, limited liability partnerships ("LLPs"), limited liability limited partnerships ("LLLPs") and other entities that had emerged since Congress introduced the "limited partnership" exception to SECA taxes back in 1977.[15]

Congressional Response to Proposed Regulations. In a remarkable demonstration of governmental gridlock and political pandering, Congress stopped the IRS in its proverbial tracks. Specifically, Congress enacted a law in 1997 expressly stating that "[n]o temporary or final regulation with respect to the definition of limited partner under Section 1402(a)(13) . . . . may be issued or made effective before July 1, 1998."[16] This essentially created a moratorium on regulations for about 18 months. If that were not enough,

[11] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), pages 40-41.

[12] Section 1402(a)(13).

[13] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).

[14] 59 Fed. Reg. 67253, EE-45-94, Prop. Reg. 1.1402(a)-18 (Dec. 29, 1994).

[15] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); REG-209729-94; 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.

[16] Taxpayer Relief Act of 1997, P.L. 105-34, section 935 (Aug. 5, 1997).

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Congress explained in the legislative history, in a segment labeled the "Sense of the Senate," that the IRS should withdraw the second set of proposed regulations defining "limited partner" and that "Congress should determine the tax law governing self-employment income."[17]

Result of Showdown between the IRS and Congress. In summary, Congress flexed its muscle to halt the IRS in 1997, declaring that only the legislative branch (i.e., Congress), and not an agency of the executive branch (i.e., the IRS), had authority to create law. Lamentably for taxpayers and the entire tax system, Congress has not issued any legislation to resolve the "limited partner" matter in two and one-half decades. The IRS, likely indignant about being rebuked by Congress and resigned to the fact that additional efforts might meet the same fate, has not advanced any regulatory actions in two and one-half decades either. As a result, those involved in disputes involving "limited partners" and SECA taxes are left with the outdated text of Section 1402(a)(13) from 1977 and a small amount of legislative history focused on Social Security funding, not tax issues.

Key Administrative Rulings and Court Cases

Section 1402(a)(13) was enacted more than four decades ago, yet the number of IRS rulings and court cases substantively addressing this critical provision are few. Some key ones are examined below.

Two Cases Involving Working Interests. The Tax Court wrestled with two cases involving taxpayers who purchased working interests in oil and gas wells, considered it an investment, did not participate in the activity, and reported the resulting income on their Forms 1040 (U.S. Individual Income Tax Returns), but did not pay SECA taxes on such amounts.

In the first case, *Johnson*, the taxpayer owned working interests in several oil and gas properties in 1987.[18] The taxpayer had limited knowledge about mineral extraction, did not participate in the operations, and was "an inactive investor." She reported the income from the working interests on her Form 1040, but she did not pay SECA taxes.

The IRS audited the taxpayer and ultimately issued a Notice of Deficiency claiming that (i) her working interests constituted carrying on a trade or business, either as a partner or through an agent, and (ii) she should have paid SECA taxes on the income distributed to her from such business. The taxpayer disputed the IRS's allegations by filing a Petition with the Tax Court. She argued that the working interests were "merely investments" and her lack of activity indicated that she was not engaged in any business.

The Tax Court held in favor of the IRS. It explained that the definition of "partnership" in the Internal Revenue Code is quite broad, encompassing syndicates, groups, pools, joint ventures, and other non-corporation organizations through which any business, operation, or venture is carried out. After reviewing the standard Operating Agreement that the taxpayer signed, the Tax Court determined that the various owners of working interests, including the taxpayer, created a pool or joint venture. Because a pool or joint venture is considered a partnership for federal tax purposes, the income that the taxpayer received is a distributive share from a partnership. Therefore, the Tax Court concluded, the general rule dictates that the taxpayer should pay SECA taxes.

The taxpayer countered that, even if she were deemed to be a partner in a partnership, she should still be free from SECA taxes because she was a "limited partner" under Section 1402(a)(13). The Tax Court did not challenge the taxpayer's minimal role, nor did it question the existence of the "limited partner" exception. However, the Tax Court emphasized that the taxpayer had failed to follow the requisite formalities. It summarized the conundrum as follows: "The short answer to this contention is that [the taxpayer] is bound by the form in which she cast her transaction" and her "argument is not persuasive because she and the other working interest owners did not take the necessary steps to comply with Texas law." In other words, the Tax Court announced that while taxpayers can form a general partnership informally, they must jump through all the proverbial hoops to create a limited partnership under state law.

In making arguments and determinations, the IRS and courts have essentially ignored other portions of the same legislative history that raise the notion of allocating income between SECA amounts and non-SECA amounts.

[17] U.S. House of Representatives, Taxpayer Relief Act of 1997, Conference Report, 105th Congress, 1st Session, Report 105-220, July 30, 1997, page 765.

[18] *Johnson*, TCM 1990-461.

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The second case, *Perry*, featured nearly identical facts, legal issues, and conclusions.[19] The Tax Court held that the taxpayer was not a "limited partner" because "state law requires that certain formalities be observed to create a limited partnership [and] there is no evidence of such formalities having been observed by the owners of the interests in the wells."

Three Private Letter Rulings about Entity Conversions. The IRS issued three private letter rulings close in time addressing various tax issues triggered by converting a general partnership into an LLC, Ltr. Rul. 9432018, Ltr. Rul. 9452024, and Ltr. Rul. 9525058. The first vaguely stated that the entity performed professional services, the second involved a group of doctors running a medical practice, and the third addressed several attorneys practicing law together. All the partners, who were to become members in LLCs, actively engaged in their respective businesses. The IRS concluded in all three instances that the new entities would be treated as partnerships for federal tax purposes. It also determined that the distributive shares received by the members would not be exempt from SECA taxes under the "limited partner" exception found in Section 1402(a)(13). The IRS's reasoning for this second conclusion was sparse, with only Ltr. Rul. 9432018 providing any specifics. It stated that the new LLC is not a limited partnership, the members of the LLC are not limited partners (although they might be treated as such in certain contexts), and the members will engage in the daily activities of and perform substantial services for the LLC. Accordingly, the income allocated to each member of the LLC constitutes "net earnings from self-employment" and should be subject to SECA taxes.

Because a pool or joint venture is considered a partnership for federal tax purposes, the income that the taxpayer received is a distributive share from a partnership. Therefore, the Tax Court concluded, the general rule dictates that the taxpayer should pay SECA taxes.

Norwood v. Commissioner. The sole issue in *Norwood* was whether the taxpayer was liable for SECA taxes on a distribution from a partnership.[20]

The taxpayer was a general partner in a medical supply company, owning nearly 51% of the interests. He worked diligently, on a full-time basis, at the company during the first few years. His participation waned after that. Indeed, once the staff was capable of operating the business without him, he essentially stopped working there. His activities were reduced to making periodic appearances and being consulted on major decisions. In 1995, the taxpayer received a distributive share, reported it on his Form 1040, and paid the corresponding income taxes. He did not pay SECA taxes, though, which the IRS disliked. The fight ended up in Tax Court.

The taxpayer argued that his role in the company was minimal and passive during 1995, such that he should be shielded from SECA taxes by the "limited partner" exception in Section 1402(a)(13). The IRS suggested that whether the taxpayer was active or passive with respect to the company is irrelevant because he was a general partner, not a limited one.

The Tax Court sided with the IRS, explaining that "[t]he passive activity rules under Section 469 have no application in this case," the taxpayer's "lack of participation in or control over the operations of [the company] does not turn his general partnership interest into a limited partnership interest," and "a limited partnership must be created in the form prescribed by state law."

Renkemeyer, Campbell & Weaver, LLP v. Commissioner. The taxpayers in *Renkemeyer, Campbell & Weaver, LLP* formed an LLP under Kansas law to operate their law practice ("Law Firm").[21] The Law Firm had three individual partners and one corporate partner in 2004. The Law Firm filed a timely Form 1065 (U.S. Return of Partnership Income) for 2004, showing revenues primarily generated by the performance of legal services. Such revenues were distributed to the individual partners, not reported as "net earnings from self-employment" by the Law Firm, and thus not subjected to SECA taxes at the partner level.

The Law Firm amended its agreement to eliminate the corporate partner starting in 2005, to create two classes of ownership interests (i.e., General Managing Partner Interests and Investment Partner Interests), and to provide for equal allocation of distributive

[19] *Perry*, TCM 1994-215.

[20] *Norwood*, TCM 2000-84.

[21] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011).

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shares. Each of the three individual partners held both types of interests in the Law Firm and had equal authority. The Law Firm made distributions to the individual partners in 2005, who, again, did not pay SECA taxes on such amounts.

The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares in 2004 and 2005 as "net earnings from self-employment," not protected by the "limited partner" exception in Section 1402(a)(13), and thus subject to SECA taxes.

The Law Firm challenged the IRS in Tax Court. The Law Firm argued that its three partners, who were partners in an LLP formed under Kansas law, should be treated as "limited partners" under Section 1402(a)(13) because (i) their interests are specifically called limited partner interests in the Law Firm's organizational documents, and (ii) the partners each had limited liability under Kansas law.

The Tax Court disagreed with the Law Firm. It began by explaining the major differences between general partners and limited partners, in terms of management power and personal liability, concluding that a limited partner interest "is generally akin to that of a passive investor."[22] The Tax Court indicated that an LLP is a different beast; it is essentially a general partnership that affords limited liability protection to all partners. The Tax Court went on to explain that the predecessor to Section 1402(a)(13), which uses the phrase "limited partner," was enacted *before* LLPs and other modern entity forms came into existence. It then recognized that the IRS attempted to address this issue many years ago, in 1997, by issuing proposed regulations, but Congress prevented the IRS from finalizing them.

Without any additional guidance since then, either from Congress or the IRS, the Tax Court indicated that it must engage in an exercise of statutory interpretation to determine what, exactly, Congress meant when it used the term "limited partner" in the context of SECA taxes and Section 1402(a)(13). It looked to just one portion of the legislative history, which stated the following:

> The bill would exclude from [SECA tax] coverage the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. *This is to exclude for [SECA tax] coverage purposes certain earnings which are basically of an investment nature.*[23]

The Tax Court believed that this "insight" showed that the intent of Congress was to ensure that individuals who merely invested in a partnership and did not actively participate in its business operations would not receive credits toward Social Security coverage. It went on to explain that the legislative history does not support the notion that Congress contemplated excluding partners who performed services for a partnership, in their capacity as partners, from liability for SECA taxes.[24]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount for their partnership interests, and the distributive shares that they received during the relevant years were not, to cite the legislative history, "earnings which are basically of an investment nature." Accordingly, the Tax Court concluded that the partners must pay SECA taxes on their distributive shares and the exception under Section 1402(a)(13) does not apply.[25]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount for their partnership interests, and the distributive shares that they received during the relevant years were not, to cite the legislative history, "earnings which are basically of an investment nature."

Riether v. United States. The key issue in *Riether* was whether taxpayers must treat the distributive shares that they received from an LLC formed in New Mexico as income subject to SECA taxes under Section 1402. The taxpayers, husband and wife, owned the LLC.[26] The husband worked as a radiologist, providing medical services through the LLC.

It appears that the taxpayers tried to apportion their income from the LLC. They reported

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[22] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 147 (2011).

[23] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011) (citing the Social Security Amendments of 1977, P.L. 95-216, section 313(b)) (emphasis added).

[24] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011).

[25] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011).

[26] *Riether*, 112 AFTR2d 2013-6074, 919 F.Supp.2d 1140 (DC N.M., 2012).

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a part as wages on Forms W-2 (Wage & Income Statement), and thus were subject to income taxes, FICA, etc. They reported the remainder as passive income not subject to SECA taxes.[27] The IRS audited the taxpayers, disagreed with the income bifurcation, and determined that the remainder from the LLC was subject to SECA taxes.

The District Court discussed the entity-classification rules and the fact that the LLC did not elect to be treated as a corporation, such that it was a partnership by default for federal tax purposes. The District Court pointed out that the only argument raised by the taxpayers was that they received a Form W-2 from the LLC, such that they were employees, and since they were employees, they were not self-employed. The District Court found this position "interesting but unpersuasive."

Citing to Rev. Rul. 69-184, the District Court said that the taxpayers should have treated *all* their income from the LLC as self-employment income because "members of a partnership are not employees of the partnership" for purposes of self-employment taxes.

Citing to Rev. Rul. 69-184, the District Court said that the taxpayers should have treated *all* their income from the LLC as self-employment income because "members of a partnership are not employees of the partnership" for purposes of self-employment taxes. The District Court said that the taxpayers were members in an LLC, not partners in a partnership. Moreover, even if the relevant entity were a partnership, the taxpayers do not resemble limited partners, who lack management powers and are not liable for debts of the partnership. The District Court thus concluded that "whether the [taxpayers] were active or passive in the production of the LLC's earnings, those earnings were self-employment income."

Howell v. Commissioner. The sole issue in *Howell* was whether the taxpayer was liable for SECA taxes on payments that she received from an LLC formed in California.[28]

The husband of the taxpayer invented the concept that led to the formation of LLC. Nevertheless, the husband decided to make his wife, the taxpayer, the primary member in the LLC because she had a better credit history. This would help the LLC in obtaining loans, credit cards, approvals, favorable interest rates, etc.

The taxpayer held a 60% interest in the LLC. The LLC entered into a Management Agreement with the husband, which delegated to him total and exclusive control of all management and operations of the LLC.

The LLC was treated as a partnership for federal tax purposes and filed a Form 1065 each year. It characterized certain amounts to the taxpayer as "guaranteed payments" on its Forms 1065, claiming the related deduction. The taxpayer, by contrast, eventually filed her Forms 1040 characterizing the same income as a distributive share, passive in nature, and not subject to SECA taxes.

The IRS started an audit of LLC, which soon broadened to cover the taxpayer, too. The IRS eventually issued a Notice of Deficiency. The taxpayer contended that none of the amounts received from the LLC should be subject to SECA taxes because (i) the LLC mistakenly characterized some amounts as guaranteed payments on its Forms 1065 and (ii) she was a limited partner and thus exempt from SECA taxes under Section 1402(a)(13).

The IRS countered that the taxpayer previously admitted that certain amounts were guaranteed payments by labeling them as such on Forms 1065 filed by the LLC and she cannot disavow her reporting position only after being caught by the IRS. The IRS further argued that the taxpayer was an active participant in the LLC, and such participation precluded her from enjoying the exclusion from SECA taxes for "limited partners."

The Tax Court explained the general rule in Section 1402, the exception for limited partners, and the fact that the key term is not defined by statute. Next, the Tax Court summarized the earlier holding and reasoning in *Renkemeyer*, emphasizing that the taxpayers in that case were not limited partners because their distributive shares arose from the legal services that they performed for the Law Firm and not from a passive return on investment.

The Tax Court then went through the two main arguments raised by the IRS. First, the

[27] *Riether*, 112 AFTR2d 2013-6074, 919 F.Supp.2d 1140 (DC N.M., 2012).

[28] *Howell*, TCM 2012-281.

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Tax Court held that the taxpayer could not disavow, after the fact, the previous classification of certain amounts as "guaranteed payments." It pointed out that the taxpayer officially controlled the LLC, provided the tax-related data to the accountant, served as the Tax Matters Partner of the LLC, signed the Forms 1065, and only attempted to change the character of the income after the IRS had started the audit and raised the SECA tax issues. Even if the taxpayer had met the criteria to disavow the earlier classification, the Tax Court said that she still failed because she could not offer "strong proof" that the original reporting by the LLC on its Forms 1065 was incorrect. The only evidence offered was a conclusory statement by the accountant, which the Tax Court found "self-serving and unreliable."

With respect to the "limited partner" argument, the Tax Court underscored that, according to the Operating Agreement for the LLC, the taxpayer contributed intellectual property, a business plan, and organizational design. She also executed the Management Agreement between her husband and the LLC. In addition, she testified that she provided marketing advice, implemented sales strategies, served as Tax Matters Partner, and used her personal credit card to purchase equipment for the LLC. Based on this, the Tax Court held that the taxpayer performed services for the LLC and was not merely a passive investor. Accordingly, the amounts she received were a distributive share subject to SECA taxes because the taxpayer was not a "limited partner."

Chief Counsel Advice 201436409. The main facts in CCA 201436409 were as follows.[29] The Management Company was an LLC treated as a partnership for federal tax purposes. It was formed to be the successor to an S corporation that previously served as investment manager to various funds. The Management Company had full authority to manage and control the business of each fund, conducted market research, and effectuated trading activity. The Management Company's primary source of income derived from management fees paid by each of the funds.

Several individuals were partners in the Management Company. They worked on a full-time basis, providing a wide range of investment-related services. The partners each held so-called "units" in the Management Company.

It appears that the Management Company bifurcated the payments to the individual partners, classifying certain amounts as guaranteed payments and subjecting them to SECA tax, and classifying the majority as payments to "limited partners" exempt from SECA tax under Section 1402(a)(13). The Management Company reasoned that it had the same role as the S corporation that it succeeded, such that it was entitled to continue following the same "reasonable compensation" principles applicable to S corporations.

The IRS offered some introductory analysis, (i) explaining that Section 1402(a)(13) was enacted in 1977 before modern business forms, like LLCs, were common; (ii) suggesting that Revised Uniform Limited Partnership Act indicates that a "limited partner" loses his status if he participates in control of the business; and (iii) summarizing the Tax Court's holdings in *Renkemeyer* and *Riether*.

The IRS then turned to the facts at hand. It indicated that the partners of the Management Company performed extensive services in their capacity as partners and generated essentially all the income for the entity. Accordingly, reasoned the IRS, such income "is not income which is basically of an investment nature of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to Section 1402(a)(13)." The IRS also opined that, even though the partners paid more than a nominal amount for their units in the Management Company, the income they received was not passive. The IRS further warned, based on the holding in *Riether*, that taxpayers, like the Management Company, cannot unilaterally change the character of distributive shares by simply labeling a portion as guaranteed payments. Finally, the IRS concluded that the Management Company was an LLC, not an S corporation, such that it cannot rely on the "reasonable compensation" rules when distributing payments to its members.

With respect to the "limited partner" argument, the Tax Court underscored that, according to the Operating Agreement for the LLC, the taxpayer contributed intellectual property, a business plan, and organizational design.

Chief Counsel Advice 201640014. The Franchisee in CCA 201640014 was the majority owner of an LLC, which was treated as a partnership for federal tax purposes.[30] The LLC owned and operated various chain restaurants, deriving most of its income from food sales.

The agreements between the Franchisee and Franchisor mandated that the Franchisee personally devote full-time and best efforts to operating the restaurants. Similarly, the Operat-

[29] CCA 201436409.

[30] CCA 201640014.

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ing Agreement for the LLC (i) named the Franchisee as President, Chief Executive Officer, and Manager; (ii) indicated that he would conduct all business affairs; and (iii) granted him authority to make all major decisions, participate in legal proceedings, enter into real property contracts, loan money, invest, oversee employees, handle correspondence, establish pension plans, appoint others to act as supervisors, hire outside accounting, legal and other professionals, etc.

The LLC bifurcated the amounts it paid to the Franchisee each year. Certain amounts were treated as guaranteed payments, similar to reasonable compensation for services provided by the Franchisee, and subject to SECA taxes. Other amounts were characterized as passive income, attributable to return on capital invested or the efforts of others, and not subject to SECA taxes. Regarding the second category, the LLC believed that the Franchisee was entitled to certain passive income thanks to the significant cash capital contributions he made, which were deployed to buy buildings and equipment, make improvements, hire employees, and more.

In addressing the limited partner exception issue, the IRS pointed out the following: (i) the Franchisee had sole authority over the LLC; (ii) he was the President, Chief Executive Officer and Manager; (iii) even though the LLC had several executive-level employees, he was the only active member of the LLC; and (iv) he participated in the LLC's operations and management, in his capacity as a member, and was not a mere investor. Consequently, the IRS determined that the Franchisee could not benefit from the "limited partner" exception in Section 1402(a)(13).

***Hardy* is a rarity in that the taxpayer prevailed on the "limited partner" issue.**

The LLC conceded that, pursuant to the legislative history, as quoted in *Renkemeyer*, service partners, like the Franchisee, are not "limited partners." However, the LLC argued that it was distinct because it derived income from the sale of products instead of services, the Franchisee made significant capital contributions to the LLC, and the Franchisee delegated management responsibilities to executive-level employees. The LLC urged the IRS to apply substance-over-form principles to allow a portion of the distributive share to the Franchisee to be treated as passive return on investment.

The IRS rejected this suggestion, indicating that the LLC was confusing the SECA tax rules for partners and the employment tax rules for corporate shareholder employees. In short, the IRS stated that the LLC "is not a corporation and the 'wage' and 'reasonable compensation' rules which are applicable to corporations . . . do not apply." The IRS went on to explain that, although the Tax Court in *Renkemeyer* identified the small capital contributions by the partners as one of the factors in its decision that the partners were not "limited partners," that case does not stand for the idea that a capital-intensive partnership should be treated like a corporation for employment tax purposes.

Hardy v. Commissioner. *Hardy* is a rarity in that the taxpayer prevailed on the "limited partner" issue.[31] The taxpayer in that case was a plastic surgeon who operated a medical practice through one LLC that he wholly owned. Surgical procedures generally have three fee components: a fee for the doctor, a fee for the anesthesiologist, and a fee for the surgical facility. The taxpayer performed medical procedures in various facilities, including Missoula Bone & Joint Surgery Center, LLC ("MBJ"). The taxpayer held a minority interest in MBJ, but he never managed it, had day-to-day responsibilities, provided input for operational decisions, or got involved with personnel matters. The taxpayer only performed surgeries at the MBJ facility about once a week, and he received a distribution from MBJ regardless of how many surgeries he did there.

The taxpayer reported passive income on his Form 1040 from MBJ during the relevant years, thus acknowledging that he was not "materially participating" for purposes of Section 469. The taxpayer did not, however, claim that he was entitled to the "limited partner" exception to SECA taxes under Section 1402(a)(13). Instead, he reported ordinary income from MBJ and paid the related SECA taxes.

The IRS audited. Among other things, it took the position that the income from MBJ was not passive, such that it could not be offset by a passive loss carryover from an earlier year. The taxpayer ultimately took his dispute to the Tax Court. One point of contention was whether the taxpayer should have paid SECA taxes on the distributions he received from MBJ. The taxpayer suggested to the Tax Court

[31] *Hardy*, TCM 2017-16.

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that he never should have paid those in the first place, and the IRS owed him a refund.

The Tax Court determined that the taxpayer did not materially participate in the activities of MBJ, such that the income flowing to him from such entity was passive for purposes of Section 469. The Tax Court then turned to the related issue; that is, whether the income from MBJ was exempt from SECA taxes under Section 1402(a)(13) because the taxpayer was a "limited partner."

The IRS argued that the taxpayer was not a "limited partner" in MBJ because he performed certain procedures at the surgical center operated by MBJ. The Tax Court rejected that contention. It acknowledged the holding in *Renkemeyer,* as well as the discussion in that case about the pertinent legislative history. However, the Tax Court pointed out that (i) the taxpayer was "an investor" in MBJ; (ii) he used the surgical facility only 10% of the time; (iii) he was not involved in the business operations of MBJ; and (iv) the patients paid MBJ for use of the medical facility, but they separately paid the taxpayer for his surgical services. Therefore, the Tax Court held that the taxpayer was a "limited partner" not subject to SECA taxes with respect to MBJ.

Castigliola v. Commissioner. The taxpayers in *Castigliola* were a group of attorneys who practiced law through a firm organized as a professional limited liability company ("PLLC") in Mississippi.[32] The PLLC was treated as a partnership for federal tax purposes, filing an annual Form 1065. During the relevant years, the firm had a Compensation Agreement, which called for certain guaranteed payments to the members. Any amounts remaining thereafter were distributed to the members.

Based on the advice of their longstanding accountant, the taxpayers reported the guaranteed payments as self-employment income and paid SECA taxes, but they did not pay SECA taxes on their distributive shares in excess of the guaranteed payments. The IRS audited the taxpayers and claimed that *all* amounts received from the PLLC should have been subject to SECA taxes. The dispute eventually found its way to Tax Court.

The Tax Court began by acknowledging and summarizing *Renkemeyer*. Based on that case, the Tax Court held that its first job was to determine whether the party claiming the benefit of the "limited partner" exception under Section 1402(a)(13) held a position that is functionally equivalent to that of a limited partner in a limited partnership.

The Tax Court examined several sources describing the characteristics of a limited partnership. It observed that the most common were limited liability and lack of control over the business. In this case, the PLLC was member-managed, such that each attorney had power over the business. The Tax Court pointed out that the PLLC lacked a written Operating Agreement or any other evidence of limitations on control. Moreover, all members actually participated in control by supervising associate attorneys and making decisions about distributive shares, borrowing money, personnel, etc. The Tax Court also underscored that the PLLC did not have at least one general partner, which is a requirement for a limited partnership. The members confirmed this, testifying that they each participated equally in decisions and had substantially identical relationships with the PLLC. For these reasons, the Tax Court determined that the taxpayers were not "limited partners" for purposes of Section 1402(a)(13).

The Tax Court examined several sources describing the characteristics of a limited partnership. It observed that the most common were limited liability and lack of control over the business.

Joseph v. Commissioner. The taxpayer in *Joseph* was a doctor, who had ownership interests in many entities, and who had trouble filing his Forms 1040 on time.[33] At some point, the IRS audited the taxpayer and then issued a Notice of Deficiency, alleging, among other things, that he owed SECA taxes with respect to certain entities. Tax Court litigation ensued.

The parties focused their attention on Greenville Avenue Surgical Partners, LP ("GASP"), a limited partnership. The taxpayer raised several defenses over the course of the litigation, first arguing that income from a partnership is never subject to SECA taxes, then suggesting that he was not taxable because he held a "limited partner interest," and finally clarifying that he should benefit from the "limited partner" exception under Section 1402(a)(13).

[32] *Castigliola*, TCM 2017-62.

[33] *Joseph*, TCM 2020-65.

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The Tax Court disagreed. It recited its earlier holding in *Renkemeyer*, suggesting that just having limited liability will not suffice, and a taxpayer can only benefit from the exception if he "is merely a passive investor in the entity who does not actively participate in the entity's business operations." In this case, the taxpayer testified that he used GASP to receive income for various surgeries he performed for another entity. Thus, the Tax Court concluded that the taxpayer "actively participated" in the business and thus was not a "limited partner" for purposes of Section 1402(a)(13).

Issue Regains Importance

Who, exactly, can benefit from the "limited partner" exception to SECA taxes has been strongly contested for generations, from 1977 to the present, and the main case, *Renkemeyer*, was decided a decade ago. Many have written about different aspects of this issue, too.[34] Although not new, this topic is now gaining serious traction again for the reasons described below.

The IRS claims that certain taxpayers are inappropriately applying Section 1402(a)(13).

Compliance Campaign. The IRS claims that certain taxpayers are inappropriately applying Section 1402(a)(13). According to the IRS, some entities treated as partnerships are classifying *all* members as "limited partners," thereby avoiding SECA taxes on partnership distributions altogether. Other partnerships are taking a more moderate approach, arguing that only a portion of the distributions should be subject to employment taxes. They accomplish this by labeling minor amounts as wages or guaranteed payments to partners on Forms W-2, while the rest is classified as a distributive share to "limited partners" and thus exempt from SECA taxes.

The IRS recently initiated a Compliance Campaign to halt these practices, summarizing the problem as follows:

> Partners report income passed through from their partnerships. Unless an individual partner qualifies as a "limited partner" for [SECA] tax purposes, the partner's distributive share is subject to [SECA taxes]. Some individual partners, including service partners in service partnerships organized as state-law limited liability partnerships, limited partnerships, and limited liability companies, have inappropriately claimed to qualify as "limited partners" not subject to SECA tax.[35]

Concept Unit. The IRS introduced a Concept Unit to its personnel to assist them in implementing the Compliance Campaign. The Concept Unit contained five noteworthy items. First, it acknowledged that Section 1402(a)(13) does not define the term "limited partner," final regulations do not exist, and, therefore, IRS personnel must rely solely on legislative history and case law in making their determinations.[36]

Second, the Concept Unit states that it is not restricted to just limited partnerships and LLCs; it applies to *all* entities treated as partnerships for federal tax purposes, including joint ventures, LLCs, LLPs, LLLPs, limited partnerships, and other entities.[37]

Third, the Concept Unit states that "individual partners *who do not have limited liability* are subject to [SECA taxes], *regardless of their participation* in the partnership's business or the capital-intensive nature of the partnership's business."[38] Thus, the IRS is reading the word "limited" twice in this context; that is, limited liability and limited activity.

Fourth, the Concept Unit instructs IRS personnel to ignore all five of the taxpayer-favorable decisions regarding limited partners and the passive activity loss-limitation rules under Section 469, which were analyzed in the third article of this series. Despite the fact that both Section 469(h)(2) and Section 1402(a)(13) contain the term "limited partner" and they both address similar issues, the Concept Unit directs IRS personnel to simply disregard as-

[34] See, e.g., Dilley, "Breaking the Glass Slipper – Reflections on the Self-Employment Tax," 54 Tax Law 65 (2000); Banoff, "Renkemeyer Compounds the Confusion in Characterizing Limited and General Partners – Part I," 115 J. Tax'n 306 (2011); Fritz, "Flowthough Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?" 17 Virginia Tax Review 811 (1998); Marquis, "Current Status of Limited Liability Companies and the Self-Employment Income Tax," 77 Michigan Bar Journal 440, May 1998; Koski, "Self-Employment Tax and Limited Liability Companies: When Are LLC Earnings Subject to Self-Employment Taxes?" 83(9) Taxes – The Tax Magazine 33 (Sept. 2005); Koski, "Partners of Law Firm Organized as LLP Held Liable for Self-Employment Tax on Distributive Share of Earnings – Uncertainty on How SE Tax Applies to LLPs and LLCs Remains," 89(8) Taxes – The Tax Magazine 37 (Aug. 2011); Koski, "Surgeon Escapes Self-Employment Tax on Distributive Share of LLC Income from Surgery Center – Application of SE Tax to LLCs Remains Unclear," 95(8) Taxes – The Tax Magazine 31 (Aug. 2017); Trivedi, "Renkemeyer Facts Limit Decision's Scope, Practitioners Say," 133 Tax Notes 555 (Oct. 31, 2011); S. Megaard & M. Megaard, "Reducing Self-Employment Taxes on Owners of LLPs and LLCs After Renkemeyer," 87 Practical Tax Strategies 52, August 2011; Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," 130 Tax Notes 1244 (Mar. 14, 2011); Karlinsky, "Self-Employment Taxes and PALs: The Case of LLCs," 132 Tax Notes 1391 (Sept. 26, 2011); Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70(4) Washington and Lee Law Review 2389 (2013).

[35] *www.irs.gov/businesses/corporations/lbi-active-campaigns.*

[36] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 10.

[37] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 3.

[38] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 13 (emphasis added).

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pects that are negative for the IRS. Specifically, the Concept Unit states that "the material participation rules under [Section] 469 have no bearing on whether an individual partner may be subject to self-employment taxes under [Section] 1402."[39]

Fifth, the Concept Unit devotes three pages to a discussion of the proposed regulations issued by the IRS in 1997, which were never finalized because Congress passed a law in 1997 temporarily preventing it.[40] Interestingly, the IRS appears to have decided to overlook the proposed status of the earlier regulations by informing taxpayers that the IRS will stand by its earlier guidance. The Concept Unit makes the following declaration in this regard:

> The 1997 Proposed Regulations are not final. They may not be enforced on taxpayers. Instead, the applicable analysis is the statutory language [in Section 1402(a)(13)], legislative history, and case law. *Taxpayers, however, may rely on the 1997 Proposed Regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 Proposed Regulations.*[41]

This announcement in the Concept Unit that the IRS will respect the taxpayer's choice of applying the proposed regulations from 1997 is consistent with at least one earlier statement, made before the Taxation Section of the American Bar Association, by a high-ranking attorney in the IRS's National Office, back in 2011. She indicated that taxpayers "could rely" on such regulations.[42] Others have explained that "IRS officials have said many times that the [IRS] will not challenge positions taken by taxpayers who rely on the proposed regulations to determine that a partner's earnings are not subject to self-employment tax."[43]

IRS Removes Issue from Its List of Priorities. In what cannot be a coincidence, the IRS discretely removed the "limited partner" and SECA tax issue from its list of priorities, just around the time that it announced its Compliance Campaign and distributed the Concept Unit to its troops. For many years, the annual "Priority Guidance Plan" published by the IRS contained the following entry: "Guidance on the application of [Section] 1402(a)(13) to limited liability companies."[44] This disappeared after 2018, without the IRS ever issuing the promised guidance.[45]

Biden Administration Urges Congressional Action. The Biden Administration recently issued its revenue proposals for 2022 ("Green Book").[46] One goal is to "rationalize" conflicting rules relating to SECA taxes. In this regard, the Green Book explains that, because Section 1402(a)(13) only refers to "limited partners," questions have arisen regarding whether it encompasses members of LLCs and owners of other pass-through entities.[47] The Green Book contains various proposals aimed at solving the perceived problem. One such proposal is passing legislation that would cause limited partners and members in LLCs who "materially participate" in a business to pay SECA taxes on their distributive shares until reaching a certain threshold.[48]

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IRS Representatives Predict More Litigation. Attorneys from the IRS's National Office announced in June 2021 that the IRS intends to continue auditing and litigating "limited partner" and SECA tax cases because it has been "fairly successful" in this area.[49]

Conclusion

This article shows that thanks to the longstanding skirmish between the IRS and Congress, there is a dearth of guidance regarding the proper treatment

39 IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 13.

40 IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, pages 19-21.

41 IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 19 (emphasis added).

42 Jackel, "Has Politics Trumped Policy?" 131 Tax Notes 745 (May 16, 2011).

43 Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," Tax Analysts Doc. 2011-5140 (Mar. 11, 2011).

44 See, e.g., U.S. Treasury Department, Office of Tax Policy and IRS, 2015-2016 Priority Guidance Plan (July 31, 2015), page 11.

45 U.S. Treasury Department, Office of Tax Policy and IRS, 2019-2020 Priority Guidance Plan – Fourth Quarter Update (Sept. 2, 2020).

46 U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021).

47 U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), page 65.

48 U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), pages 66-67. Note the incongruity here: The IRS states in its recent Concept Unit that the SECA tax rules in Section 1402(a)(13) and the passive activity loss-limitation rules in Section 469 are completely unrelated, whereas the Biden Administration is taking the opposite approach in the Green Book, encouraging Congress to pass laws expressly stating that the two sets of rules should be inextricably linked.

49 Taylor, "Clarity regarding 'Limited Partner' under SECA Remains Elusive," 2021 Tax Notes Today Federal 112-2 (June 11, 2021).

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of the "limited partner" exception to SECA taxes under Section 1402(a)(13). It also demonstrates that the lack of administrative or legislative direction for applying antiquated concepts, like traditional "limited partners," to modern business entities has obligated the courts to rely on inadequate tools. These consist mainly of statutory interpretation, which is an inexact science, at best, and review of legislative history, or just parts of it. This situation has led to inconsistent decisions by the courts, fueled by inconsistent positions by the IRS.

Despite all the uncertainty, one thing is clear: The Compliance Campaign, Concept Unit, Priority Guidance Plan, Green Book, and recent announcements by high-ranking officials confirm that the IRS intends to attack various entities treated as partnerships that have claimed exemptions from SECA taxes thanks to the "limited partner" exception. Taxpayers, therefore, need to follow closely this evolving issue in preparation to defend themselves. ■