

LB&I Concept Unit

Unit Name	Self-Employment Tax and Partners	
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Book	Self-Employment and Net Investment Income Tax
Chapter	Basic Concepts

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General Overview

Self-Employment Tax and Partners

Note: This replaces the practice unit with the same title dated 2/13/19. The practice unit was revised to reference updated training material on slide 24.

This concept unit focuses on the circumstances in which an individual partner's distributive share of income is subject to Self-Employment Contributions Act (SECA) tax, also known as self-employment tax. In general, unless an exception applies, an individual partner's distributive share of a partnership's ordinary business income is included in net earnings from self-employment under IRC 1402(a) and subject to SECA tax. In this unit, the terms "SECA tax" and "self-employment tax" are used interchangeably.

IRC 1402(a) provides several exceptions. In particular, IRC 1402(a)(13) provides an exclusion from SECA tax for a "limited partner's" distributive share of partnership income other than guaranteed payments to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are in the nature of remuneration for those services.

This concept unit applies to all arrangements treated as partnerships for federal tax purposes, which may include joint ventures, limited liability companies (LLCs), limited liability partnership (LLPs), limited partnerships (LPs), and limited liability limited partnerships (LLLPs). However, if an entity such as an LLC is treated as a corporation for federal tax purposes (for example, if the LLC "checked the box" to be a corporation), this concept unit does not apply.

Detailed Explanation of the Concept

Self-Employment Tax and Partners

Circumstances in which an individual partner's distributive share of income is subject to self-employment tax.

Analysis	Resources
<u>Background</u> Signed into law in 1935, the Social Security Act created a program of financial security for individuals and their families through old-age pensions, disability benefits, and survivor benefits. While the Social Security Administration is responsible for paying benefits, the Internal Revenue Service administers the taxation provisions which fund the benefits. The Federal Insurance Contributions Act (FICA) of 1935 imposed a tax on wages to fund the Social Security program. Generally, employers and employees pay "employment tax," also known as FICA tax. However, partners in a partnership cannot be employees of the partnership, but are generally considered "self-employed." Other individuals, such as sole-proprietors and independent contractors, are also generally considered "self-employed." Beginning in the 1950s, the Self Employment Contributions Act brought partners, sole-proprietors, and other self-employed individuals into the Social Security system. Under SECA, individual partners who work in the partnership's business are subject to SECA tax on their "net earnings from self-employment." Sole proprietors reporting business on Schedule C are also generally subject to SECA tax on their "net earnings from self-employment." Corporate partners are not subject to self-employment tax.	▪ Federal Insurance Contributions Act of 1935 ▪ Self-Employment Contributions Act of 1954 ▪ IRC 1402(a) ▪ IRC 1402(b) ▪ Rev. Rul. 69-184

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Net Earnings from Self-Employment</u> IRC 1401(a) and IRC 1401(b) impose, respectively, for each taxable year, Old-Age, Survivors, and Disability Insurance tax and Hospital Insurance tax on the self-employment income of every individual. IRC 1402(b) generally provides that the term “self-employment income” means the net earnings from self-employment derived by an individual during any taxable year. IRC1402(a) generally defines the term “net earnings from self-employment” as the gross income derived by an individual from any trade or business carried on by such individual, less certain deductions which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in IRC 702(a)(8) from any trade or business carried on by a partnership of which he is a member, with certain enumerated exclusions. Generally, a partnership’s ordinary business income from operations is described in IRC 702(a)(8). A partner’s distributive share of a partnership’s ordinary business income from operations is generally subject to SECA tax unless an exception applies.	▪ IRC 1401(a) ▪ IRC 1401(b) ▪ IRC 1402(a) ▪ IRC 1402(b) ▪ IRC 702(a)(8)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Net Earnings from Self-Employment – Exclusions</u> IRC1402(a)(1)-(17) provides several exclusions from net earnings from self-employment and this general SECA tax rule. Some of these exceptions do not normally arise in the partnership context, so are not discussed here. The most common exclusions are discussed on Slides 8-21. In particular, slides 11-21 address the exclusion for limited partners under IRC 1402(a)(13).	▪ IRC 1402(a)(1)-(17)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Rental Income</u> Generally, rental income is not considered income from self-employment and is not subject to SECA tax unless the rental amounts are received as part of a real estate dealer's trade or business. Note that income from equipment leasing does not fall under this exclusion and is subject to SECA tax. To illustrate, John is an LLC member in a real estate partnership that owns a commercial building. John also owns a medical equipment leasing business as a sole proprietor. John's income from equipment leasing is subject to SECA tax unless another exception applies, but his distributive share of rental income from the real estate partnership is excluded from SECA tax under IRC 1402(a)(1). <u>Interest Income</u> In general, interest income is not subject to SECA tax. However, interest received in the course of a trade or business is subject to SECA tax. Therefore, interest received by a pawnbroker on his loans or interest received by a merchant on his accounts are subject to SECA tax because the interest is received in the course of the pawnbroker's or the merchant's trade or business. Treas. Reg. 1.1402(a)-5(b).	▪ IRC 1402(a)(1) ▪ IRC 1402(a)(2) ▪ Treas. Reg. 1.1402(a)-5(b) ▪ Eddie Cordes Inc. et al. v. C.I.R., T.C. Memo 2002-125

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis	Resources
<u>Certain Property Dispositions</u> IRC 1402(a)(3) excludes the following types of income: ▪ Gain or loss from the sale or exchange of capital assets ▪ Gain or loss from the disposition of timber, coal, or iron ore if IRC 631 applies ▪ Gain or loss from the disposition of certain types of property It is important to note what type of property is not included in the third category. If the property is held primarily for sale to customers in the ordinary course of a trade or business, or if the property is stock in trade, or property that is considered inventory, then income from the sale of that property is not excluded under IRC 1402(a)(3). In other words, income from the sale of inventory to customers is subject to SECA tax.	▪ IRC 1402(a)(3)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Partners in Community Property States</u> Section 1402(a)(5) contains an exclusion from self-employment tax for spouses of partners in community property states. It generally provides that if any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss, the partner conducting the business, and not the partner's spouse, includes the community income or loss in earnings from self-employment. <u>Certain Payments to Retired Partners</u> Section 1402(a)(10) excludes certain periodic, lifetime payments to retired partners.	▪ IRC 1402(a)(5) ▪ IRC 1402(a)(10)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Limited Partner Exclusion</u> IRC 1402(a)(13) states: There shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner 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.  CAUTION: The statute does not define a “limited partner.” There are no final regulations under IRC 1402(a)(13). As a result, application of IRC 1402(a)(13) depends on the statute, legislative history, and case law.	▪ IRC 1402(a)(13) ▪ IRC 707(c)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis

Resources



CAUTION: S corporation shareholders are subject to “reasonable compensation” rules. In contrast, partnerships generally are not required to pay partners guaranteed payments. The concept of “reasonable compensation” does not exist for partnerships and partners in the same way that it does for S corporations and shareholders.

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis

Limited Partner Exclusion – History

IRC 1402(a)(13) was originally enacted as IRC 1402(a)(12) at a time (1977) before entities such as LLCs were widely used. At the time of the statute's enactment, the Revised Uniform Limited Partnership Act of 1976 provided that a "limited partner" loses his limited liability protection if, in addition to the exercise of his rights and powers as a limited partner, he takes part in controlling the business.

In creating the exclusion for limited partners, Congress stated:

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 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 coverage purposes certain earnings which are basically of an investment nature. However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership.

Resources

- IRC 1402(a)(13)
- Revised Uniform Limited Partnership Act (1976), sec. 303(a), 6B U.L.A. 180 (2008)
- H Rept 95-702 (Part 1) at 11 (1977)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis

Limited Partner Exclusion – Partners with Unlimited Liability

Individual partners who do not have limited liability are subject to self-employment tax regardless of their participation in the partnership's business or the capital-intensive nature of the partnership's business.

Several Tax Court cases involved individuals who owned working interests in oil and gas joint ventures, but did not participate in the business operations. Joint ventures are not formed under a state-law entity such as an LP, LLC, LLP which provides for limited liability. In each case, the Tax Court found that the joint ventures constituted partnerships for federal tax purposes and the petitioners were subject to self-employment tax on their earnings from the joint venture, notwithstanding the petitioners' lack of participation.



CAUTION: The material participation rules under IRC 469 have no bearing on whether an individual partner may be subject to self-employment tax under IRC 1402(a).

Resources

- IRC 1402(a)
- Methvin v. Commissioner of Internal Revenue, T.C. Memo. 2015-81
- Cokes v. Commissioner, 91 T.C. 222 (1988)
- Perry v. C.I.R., T.C. Memo 1994- 215

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis

Limited Partner Exclusion – Partners with Limited Liability (cont'd)

For partners in entities that provide for limited liability, such as LPs, LLCs, LLPs, and LLLPs, determining whether IRC 1402(a)(13) applies is more complex. The leading case on this issue is *Renkemeyer, Renkemeyer, Campbell, and Weaver, LLP* was a law firm organized as a limited liability partnership. The partners were three attorneys and an S corporation owned by a tax-exempt employee stock ownership plan (ESOP) whose beneficiaries were the three attorneys. After reallocating income away from the ESOP partner and to the attorney partners, the court determined that the attorney partners were not “limited partners,” and therefore their distributive shares of income were subject to self-employment tax.

The *Renkemeyer* case is significant in that the court reviewed and analyzed the legislative history and legislative intent of IRC 1402(a)(13). The court noted:

...the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership’s business operations (which was the archetype of limited partners at the time) would not receive credits towards Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons) from liability for self-employment tax.

Resources

- IRC 1402(a)(13)
- *Renkemeyer, Campbell & Weaver, LLP v. C.I.R.*, 136 T.C. 137 (2011)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Limited Partner Exclusion – Partners with Limited Liability (cont'd)</u> Several cases rely on the Renkemeyer opinion. The Tax Court in Hardy v. Commissioner favorably cited the Renkemeyer analysis. The Tax Court determined that Dr. Hardy was a limited partner because he was a mere investor in the LLC. The LLC operated a surgical facility; its revenue came from fees for the use of the facility, and not fees for personal services. In contrast to the taxpayer-attorneys in Renkemeyer who acted in the manner of self-employed persons, Dr. Hardy did not manage or administer the surgical facility. Therefore, his distributive share of income was not subject to SECA tax. The Court also relied on Renkemeyer in Castigliola v. Commissioner on similar facts to the facts in Renkemeyer. The taxpayers were partners in an LLC law firm working full time providing services and overseeing employees. The LLC paid each partner substantial guaranteed payments. The taxpayers claimed that only the guaranteed payments, and not their full distributive share of net earnings, were subject to SECA tax. The court applied the Renkemeyer analysis in determining that the taxpayers were not limited partners for purposes of IRC 1402(a)(13).	▪ Hardy v. Commissioner, T.C. Memo. 2017-16 ▪ Castigliola v. Commissioner, T.C. Memo. 2017-62

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis

Limited Partner Exclusion – Partners with Limited Liability (cont'd)

The Tax Court in *Riether v. United States* also favorably cited the *Renkemeyer* analysis and ruled in favor of the government. Dr. Riether was a radiologist. He and his spouse were members of a medical diagnostic imaging LLC. The LLC improperly paid wages to Dr. and Mrs. Riether, and they did not subject their distributive shares of LLC income to self-employment tax. The taxpayers asserted two arguments: first, they argued that because the LLC issued each of them a Form W-2 in addition to the Schedule K-1, they were not self-employed, but rather were employees of the partnership; second, they argued that the income from the LLC was “unearned income not subject to the self-employment tax.”

The court determined that Dr. and Mrs. Riether did not resemble limited partners and therefore their distributive shares of income were subject to self-employment tax. The court stated:

The Revenue Code says the self-employment tax applies to a taxpayer’s distributive share of partnership income. IRC 1402(a). Only one relevant exception exists, and it applies to limited partners.... For a taxpayer treated as a general partner, however, the distributive share of partnership income is subject to self-employment tax ‘irrespective of the nature of his membership’.

The Court cited to *Renkemeyer* in determining that the taxpayers were not “limited partners.”

Resources

- *Riether v. United States*, 919 F. Supp. 2d 1140 (2012)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners

Analysis	Resources
<u>Limited Partner Exclusion – Partners with Limited Liability (cont'd)</u> The Office of Chief Counsel issued two CCAs on IRC 1402(a)(13): <u>Chief Counsel Advice – CCA 201436049</u> This Chief Counsel Advice addressed an LLC treated as a partnership. The LLC was in the business of investment management; its source of income was fees for investment management services, trading services, analyst services, and other professional services such as accounting and legal services. The LLC members were individuals who worked full time in the business and received wages. The LLC had previously been an S corporation. The LLC asserted that because it had the same role and business as the S corporation had, it could continue to apply the same “reasonable compensation” wage rules applicable to corporations. Additionally, it asserted that the partners were limited partners for purposes of the IRC 1402(a)(13) exception. The CCA concluded that the LLC could not change the character of its partners’ distributive shares by mislabeling a portion of each partner’s distributive share as “wages.” Additionally, because the LLC was not a corporation, the “reasonable compensation” rules did not apply. The CCA concluded that the partners were not limited partners within the meaning of IRC 1402(a)(13) and they were subject to self-employment tax on their distributive shares of the LLC’s income.	▪ IRC 1402(a)(13) ▪ CCA 201436049

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Limited Partner Exclusion – Partners with Limited Liability (cont'd)</u> <u>Chief Counsel Advice – CCA 201640014</u> This Chief Counsel Advice addressed whether the franchisee of a chain of restaurants was a limited partner in the LLC. The franchisee was the president and manager of the business. The franchisee owned the majority of the LLC interests; his spouse and her irrevocable trust owned the remaining interests. The LLC agreement provided for only one class of interest. The franchisee directed the LLC's operations and had the authority to enter into contracts, hire and fire the employees, and hire professionals such as accountants and attorneys. The LLC paid the franchisee guaranteed payments. The franchisee claimed that only the guaranteed payments, and not the franchisee's full distributive share of net earnings, were subject to SECA tax. The CCA concluded that the franchisee was not a limited partner within the meaning of IRC 1402(a)(13). He was subject to self-employment tax on his entire distributive share of the LLC's income, and not just on the guaranteed payments. The CCA pointed out that the IRC 1402(a)(13) exclusion for limited partners is not determined with reference to a reasonable return on capital, the presence of a guaranteed payment, or the capital intensive nature of the partnership's business. The IRC 1402(a)(13) exclusion is based on the status of the partner, not the source of the income.	▪ IRC 1402(a)(13) ▪ CCA 201640014

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Limited Partner Exclusion – 1997 Proposed Regulations</u> In 1997, the Treasury Department and the IRS promulgated proposed regulations defining “limited partner” for IRC 1402(a)(13) purposes. The 1997 proposed regulations applied to all partnerships (including LLCs). Congress imposed a temporary moratorium on finalizing the 1997 proposed regulations, which expired in 1998; however, the 1997 proposed regulations have not been finalized.  CAUTION: The 1997 Proposed Regulations are not final. They may not be enforced on taxpayers. Instead, the applicable analysis is the statutory language, 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.	▪ IRC 1402(a)(13) ▪ Prop. Treas. Reg. 1.1402(a)-2(h) ▪ Taxpayer Relief Act of 1997, Pub. L. 105-34, sec. 935, 111 Stat. 882

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Limited Partner Exclusion – 1997 Proposed Regulations (cont'd)</u> <u>General Three-Prong Test</u> The 1997 proposed regulations provide a three-prong test to determine when a partner should be treated as a limited partner. An individual generally is treated as a limited partner unless the individual: 1. Has personal liability for the debts or claims against the partnership due to being a partner; or 2. Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or 3. Participates in the partnership's trades or businesses for more than 500 hours during the partnership's taxable year. In other words, if the partner falls into any of the above situations, the partner generally is not a limited partner. Additional rules are discussed on the next slide.	▪ Prop. Treas. Reg. 1.1402(a)-2(h) ▪ Prop. Treas. Reg. 1.1402(a)-2(h)(3) ▪ Prop. Treas. Reg. 1.1402(a)-2(h)(4)

Detailed Explanation of the Concept (cont'd)

Self-Employment Tax and Partners	
Analysis	Resources
<u>Limited Partner Exclusion – 1997 Proposed Regulations (cont'd)</u> <u>Bifurcation or “Piggy-Back” Rules</u> The 1997 proposed regulations allow an individual who is not a limited partner to nonetheless exclude a portion of that individual's distributive share if the individual holds more than one class of interest in the partnership. Similarly, the proposed regulations permit an individual that participates in the trade or business of the partnership to bifurcate his or her distributive share by disregarding guaranteed payments for services. In each case, however, such bifurcation of interests is permitted only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners under the proposed regulation (without regard to the bifurcation rules) and who own a substantial, continuing interest in the partnership. <u>Service Partnership Override</u> Under the 1997 proposed regulations, if substantially all of the partnership's activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business is not considered a limited partner, regardless of what the other rules may provide.	▪ Prop. Treas. Reg. 1.1402(a)-2(h) ▪ Prop. Treas. Reg. 1.1402(a)-2(h)(3) ▪ Prop. Treas. Reg. 1.1402(a)-2(h)(4)

Index of Referenced Resources

Self-Employment Tax and Partners
IRC 702(a)(8)
IRC 707(c)
IRC 1401
IRC 1402
Treas. Reg. 1.1402(a)-5(b)
Prop. Treas. Reg. 1.1402(a)-2h
Rev. Rul. 56-675
Rev. Rul. 69-184
CCA 201436049
CCA 201640014
Castiglia v. Commissioner, T.C. Memo. 2017-62
Cokes v. Commissioner, 91 T.C. 222 (1988)
Eddie Cordes Inc. et al. v. C.I.R., T.C. Memo 2002-125
Hardy v. Commissioner, T.C. Memo 2017-16
Methvin v. Commissioner of Internal Revenue, T.C. Memo. 2015-81
Perry v. C.I.R., T.C. Memo 1994- 215

Index of Referenced Resources (cont'd)

Self-Employment Tax and Partners

Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011)

Riether v. United States, 919 F. Supp. 2d 1140 (2012)

Federal Insurance Contributions Act of 1935

Revised Uniform Limited Partnership Act (1976)

Self-Employment Contributions Act of 1954

Taxpayer Relief Act of 1997

H Rept 95-702 (Part 1) at 11 (1977)

Training and Additional Resources

Self-Employment Tax and Partners	
Type of Resource	Description(s)
Issue Toolkits	▪ Issue Snapshot, Limited Liability Company Members and Self-Employment Tax ▪ Issue Snapshot, Guaranteed Payment Subject to Self-Employment Tax Offset by Partner's Share of Loss
Other Training Materials	▪ Overview of Self-Employment Tax and Net Investment Income Tax for Partnerships, ITM 79120r

Glossary of Terms and Acronyms

Term/Acronym	Definition
CCA	Chief Counsel Advice
ESOP	Employee Stock Ownership Plan
FICA	Federal Insurance Contributions Act
LLC	Limited Liability Company
LLLP	Limited Liability Limited Partnership
LLP	Limited Liability Partnership
LP	Limited Partnership
SECA	Self-Employment Contributions Act

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
	None at this time.