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Memorandum

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from: Chief, Employment Tax Branch 1
Office of Division Counsel/Associate Chief Counsel
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subject: Section 1402(a)(13) and Investment Management Partnership

This Chief Counsel Advice responds to your request for assistance, and was drafted in coordination with the Office of Associate Chief Counsel (Passthroughs & Special Industries). This advice may not be used or cited as precedent.

LEGEND

Managed Fund =

Profits GP =

Partners =

Management Company =

State 1 =

State 2 =

A =

B =

C =

D =

E =

F =

G =

H =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

ISSUE

Whether Partners of Management Company, a partnership whose primary source of income is from fees for providing investment management services, are "limited partners" exempt from self-employment tax under Internal Revenue Code (Code) § 1402(a)(13) on their distributive shares of Management Company's income?

CONCLUSION

Partners of Management Company are not "limited partners" within the meaning of § 1402(a)(13) and are subject to self-employment tax on their distributive shares from Management Company.

FACTS

Management Company, a State 1 limited liability company (LLC) treated as a partnership for federal tax purposes, serves as the investment manager for Managed Fund. Managed Fund is a family of investment partnerships founded in Year 1. Management Company was formed in Year 2 to be the successor to an S corporation which formerly served as the investment manager for Managed Fund. Managed Fund had approximately $A assets under management as of Year 3. Managed Fund conducts its investment activity through B State 2 limited partnerships (the Funds),

which are partnerships for federal tax purposes. Each Fund carries on extensive trading and investing activity and has passive investors that are limited partners under State 2 law (the Limited Partners). The Limited Partners are passive investors in the Funds, and the limited partnership agreements provide that the Limited Partners shall not take part in or interfere in any manner with the conduct or control of the Fund's activities and have no right or authority to act for or bind the Fund.

Each Fund has two general partners for State 2 law purposes: Profits GP and Management Company. Profits GP generally does not take part in the conduct or control of the activities of the Funds, but has a substantial interest in each Fund's gains and losses. Management Company, not Profits GP, is the subject of this advice.

Management Company generally has full authority and responsibility to manage and control the affairs and business of each Fund. Thus, Management Company is primarily responsible for carrying out the extensive market research and trading activity of each of the Funds. Thus, it carries on all investment activities, such as the purchasing, managing, restructuring, and selling of the Funds' investment assets. Partners of Management Company and its employees provide these extensive services to the Funds. Management Company's primary source of income is from fees for providing management services to the Funds. In addition to its small ownership interest in each of the Funds, Management Company's assets consist primarily of cash, office equipment, and an aircraft.

In consideration of Management Company's services, the limited partnership agreements of each the Funds provide for payment of a quarterly management fee from the Fund to Management Company based upon each Fund's assets under management, and generally calculated as a percentage of each Limited Partner's capital account in the Fund.

Management Company is under examination by the Internal Revenue Service (IRS) for Year 3 and Year 4. In the years at issue, Management Company's gross receipts were entirely attributable to management fees for providing services to the Funds, and Management Company's net ordinary business income was comprised entirely of income from the management fees, rather than a distributive share from the Funds.[1]

In Year 3 and Year 4, Management Company had C and D Partners, respectively, all of whom were individuals.[2] Each Partner of Management Company worked full time, in excess of F hours each year, for Management Company. Partners performed a wide

[1] Management Company did receive a distributive share of other items from the Funds, including capital gains, interest, dividends, and rents. As described below, because those items of Management Company's income are not described in § 702(a)(8), they are not the subject of this advice. In addition to the limited partner exclusion, § 1402 contains other exclusions, such as for rental real estate income and dividends and interest. The only item at issue here is the non-separately stated ordinary business income derived from fees for investment management services.

[2] E Partners held interests through grantor trusts.

range of professional services, including investment management services, analyst services, trading services, portfolio management services, accounting services, tax services, information technology services, settlement services, legal services, human relations services, client services, and administrative support services. Some Partners performed trading and analysis services directly for the Funds on behalf of Management Company, while other partners performed operational and support services for Management Company itself. Each of the Partners received Forms W-2 for both Year 3 and Year 4 from Management Company for wage amounts received which ranged from $G to $H.

Several of Management Company's Partners have been partners since Management Company was formed. Other Partners were formerly non-partner employees who were given an opportunity to buy interests (Units) in Management Company. From time to time, select existing Partners are given the opportunity to purchase additional Units in Management Company. Management Company states that the offer to purchase Units in Management Company at the net asset book value of Management Company is extended by Management Company's senior management to Partners based upon current performance, tenure, and future potential performance. Restrictions apply to the Units held by Partners; in particular, Management Company's LLC agreement provides that Partners must sell their Units back to Management Company upon death, disability, retirement, or termination of employment.

Management Company issues Units classified as Class A Common Units, Voting Class B Common Units, and Non-Voting Class B Common Units. As a result of their ownership of Units, each Partner of Management Company is allocated a distributive share of Management Company's taxable income, including the ordinary business income attributable to the management fees. Although Management Company has several different classes of Units outstanding, Management Company's taxable income is allocated pro rata based on each Partner's total Units, regardless of class.

In Year 3 and Year 4, Management Company treated all of its Partners as limited partners not subject to self-employment tax on their distributive share. The only amount reported as subject to self-employment tax were guaranteed payments which represent health insurance premium and parking benefits paid on behalf of Partners by Management Company.

Management Company states that the "wage" amounts represent "reasonable compensation" for each Partner, and that each Partner is a limited partner with respect to their distributive share. Management Company reasons that because Management Company has the same role and business as the S corporation it succeeded, it can continue to apply the same "reasonable compensation" wage rules applicable to corporations.

LAW AND ANALYSIS

Sections 1401(a) and (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.

Section 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.

Section 1402(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 § 702(a)(8) from any trade or business carried on by a partnership of which he is a member, with certain enumerated exclusions.

Section 702(a)(8) provides that in determining his income tax, each partner shall take into account separately his distributive share of the partnership's taxable income or loss, exclusive of items requiring separate computation under other paragraphs of § 702(a).

Section 1402(a) provides several exclusions from the general self-employment tax rule. In particular, § 1402(a)(13) provides:

> 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 § 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.

Section 1402(a)(13) was originally enacted as § 1402(a)(12) at a time (1977) before entities such as LLCs were widely used. The applicable statute did not, and still does not, define a "limited partner."[3] At the time of the statute's enactment, the Revised Uniform Limited Partnership Act of 1976 provided that a "limited partner" would lose his limited liability protection if, in addition to the exercise of his rights and powers as a

[3] In 1997, the Treasury Department and the IRS promulgated proposed regulations defining "limited partner" for § 1402(a)(13) purposes. They generally provide that an individual is treated as a limited partner unless the individual: (1) has personal liability for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership; or (3) participates in the partnership's trade or business for more than 500 hours. The 1997 proposed regulations also provide exceptions for certain holders of classes of interest that are identical to those held by limited partners. Additionally, the 1997 proposed regulations provide that service providers in service partnerships (e.g., law firms, accounting firms, and medical practices) may not be limited partners. 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 were never finalized.

limited partner, he takes part in the control of the business. Revised Unif. Ltd. Pship. Act (1976), sec. 303(a), 6B U.L.A. 180 (2008).

The legislative history for the exception in § 1402(a)(13) clarifies that Congress did not intend to allow service partners in a service partnership acting in the manner of self-employed persons to avoid paying self-employment tax. 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.

H. Rept. 95–702 (Part 1), at 11 (1977) (emphasis added).

In *Renkemeyer, Campbell, and Weaver LLP v. Commissioner,* 136 T.C. 137 (2011), the Tax Court ruled that practicing lawyers in a law firm organized as a Kansas limited liability partnership (LLP) were not limited partners within the meaning of § 1402(a)(13) and thus were subject to self-employment taxes. The court discussed Kansas state law under which an LLP is considered a general partnership. The court discussed the ordinary meaning of the term "limited partnership." The court stated:

> A limited partnership has two fundamental classes of partners, general and limited. General partners typically have management power and unlimited personal liability. On the other hand, limited partners lack management powers but enjoy immunity from liability for debts of the partnership. 1 Bromberg & Ribstein, Partnership, sec. 1.01(b)(3) (2002–2 Supp.). Indeed, it is generally understood that a limited partner could lose his limited liability protection were he to engage in the business operations of the partnership. Consequently, the interest of a limited partner in a limited partnership is generally akin to that of a passive investor. See 3 Bromberg & Ribstein, *supra* sec. 12.01(a) (1988).

Renkemeyer, 136 TC at 147, 148. The court also discussed the legislative history of § 1402(a)(13) quoted above, and concluded that

> The insight provided reveals that the intent of § 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 toward Social Security coverage. The legislative history of § 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 taxes.

Id. at 150.

The *Renkemeyer* court then turned to the facts of the case and concluded that the partners were not limited partners within the meaning of § 1402(a)(13) and that their distributive share of the partnership's fee income was subject to self-employment tax:

> Aside from a nominal amount of income arising from recognition of certain pass-through income from [a corporate partner of the law firm] all of the law firm's revenues were derived from legal services performed by petitioner and Messrs. Campbell and Weaver in their capacities as partners. Petitioner and Messrs. Campbell and Weaver each contributed a nominal amount ($110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not "earnings which are basically of an investment nature." Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm.

Id.

In *Riether v. United States,* 919 F.Supp.2d 1140 (D. N.M. 2012), the District Court granted the government's motion for summary judgment on the issue of whether a husband and wife (the Plaintiffs) were subject to self-employment tax on their distributive shares from an LLC partnership. The Plaintiffs asserted two arguments: first, they argued that because the LLC issued them each 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 addressed the Plaintiffs' first argument as follows:

> Plaintiffs' only response to the Government's argument is a simplistic syllogism. They say: "Dr. & Mrs. Riether each received a Form W–2 from their employer, New Mexico Diagnostic Imaging, LLC, for the year 2006. Thus, they were not self-employed." This argument is interesting, but unpersuasive. Plaintiffs tried to treat themselves as employees for *some* of the LLC's earnings, by issuing themselves $51,500 in wages ($25,750 to

> each), while simultaneously treating themselves as partners for *the rest* of the LLC's earnings, by issuing themselves Schedules K–1 for $76,986 ($38,493 to each). (*See* 2006 Form 1040 at lines 7, 17 (Dkt. No. 50–1 at 1); 2006 Form 1065 (Dkt. No. 53–2 at 2–3).) The income at issue is not the income they treated as "wages," but the income they treated as their distributive share of partnership income. Plaintiffs' characterization of some of the income as wages does not change the character of the remaining income.
>
> In fact, Plaintiffs should have treated all the LLC's income as self-employment income, rather than characterizing some of it as wages. Revenue Ruling 69–184 says "members of a partnership are not employees of the partnership" for purposes of self-employment taxes. Rev. Rul. 69–184, 1969–1 C.B. 256. Instead, a partner who participates in the partnership business is "a self-employed individual." Id. Because Plaintiffs did not elect the benefits of corporate-style taxation under Treasury Regulation § 301.7701–3(a), they should not have treated themselves as employees in distributing the remaining $51,500 of the LLC's income. The IRS made no bones about this, however, presumably because Plaintiffs had paid self-employment tax on that income through withholding. But the LLC's improper treatment of the "wage" income further undermines Plaintiffs' simplistic argument that they owed no self-employment taxes simply because they received W–2s.

Riether, 919 F.Supp.2d 1140, at 1159.

The court was also dismissive of the second argument:

> The magic words "unearned income" won't do the trick. The Revenue Code says the self-employment tax applies to a taxpayer's distributive share of partnership income. I.R.C. § 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." Treas. Reg. § 1.1402(a)–2(g). See also *Ding v. Comm'r*, 74 T.C.M. (CCH) 708 at *2 (1997) (noting that partnership earnings other than those received by a limited partner generally constitute self-employment income). Plaintiffs are 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." *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 T.C. 137, 147 (2011). Thus, whether Plaintiffs were active or passive in the production of the LLC's earnings, those earnings were self-employment income. Summary judgment is appropriate on this issue.

Id. at 1159, 1160.

Revenue Ruling 69-184, 1969-1 C.B. 256, provides that bona fide members of a partnership are not employees of the partnership under the usual common law rules applicable in determining the employer employee relationship. The revenue ruling provides that a partner who devotes his time and energies in the conduct of the trade or business of the partnership, or in providing services to the partnership, as an independent contractor, is in either case a self-employed individual rather than an individual who has the status of an employee.

In general, a partner must include his distributive share of partnership income in calculating his net earnings from self-employment. Fees for services, like those generated by an investment management company, are part of the partners' distributive shares under § 702(a)(8). Consequently, such fees are included in calculating net earnings from self-employment, unless an exclusion applies.

Management Company has taken the position that Partners are limited partners for purposes of the exclusion in § 1402(a)(13).

Management Company is an LLC. Partners perform extensive investment and operational management services for the partnership in their capacity as partners (i.e., acting in the manner of self-employed persons) and Management Company derives its income described in § 702(a)(8) from the investment management services performed by Partners. The income earned by Partners through Management Company 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 § 1402(a)(13). Accordingly, Partners of Management Company are not limited partners within the meaning of § 1402(a)(13) and they are subject to self-employment tax on their distributive shares of Management Company's income described in § 702(a)(8).

Like the situation in *Renkemeyer*, Partners' earnings are not in the nature of a return on a capital investment, even though Partners paid more than a nominal amount for their Units. Rather, the earnings of each Partner from Management Company are a direct result of the services rendered on behalf of Management Company by its Partners. Similar to *Reither*, Management Company cannot change the character of its Partners' distributive shares by paying portions of each Partners' distributive share as amounts mislabeled as so-called "wages." Management Company is not a corporation and the "reasonable compensation" rules applicable to corporations do not apply.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Jeanne Royal Singley at or Benjamin Weaver at if you have any further questions.

Sincerely,

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