Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201640014**
Release Date: 9/30/2016

CC:TEGE:EOEG:ET1:EMRogers
POSTN-118368-16

UILC: 1402.01-03

date: June 15, 2016

to: Associate Area Counsel,
(Large Business and International)

from: Senior Technician Reviewer
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subject: Section 1402(a)(13) and Food Services 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

Franchisee =

Partnership =

State =

City =

Company =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

K =

L =

M =

N =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

ISSUE

Whether Franchisee, the Operating Manager, President, and Chief Executive Officer of Partnership, a partnership which operates restaurants, is a "limited partner" exempt from self-employment tax under Internal Revenue Code § 1402(a)(13) on his distributive share of Partnership's income?

CONCLUSION

Franchisee is not a "limited partner" in Partnership within the meaning of § 1402(a)(13) and is subject to self-employment tax on his distributive share from Partnership.

FACTS

In Year 1, Franchisee purchased A Company franchise restaurants in the area of City and contributed the restaurants to Partnership, a State limited liability company (LLC) formed in Year 1 and treated as a partnership for federal tax purposes. B of the restaurants have closed. Franchisee, individually, continues to be the franchisee for each of the remaining C restaurants, and operates them through Partnership.

Partnership is under examination by the Internal Revenue Service (IRS) for Year 2, Year 3, and Year 4. In the years at issue, Partnership's gross receipts and net ordinary business income were almost entirely attributable to food sales.

Franchisee owns the majority of Partnership (D percent). During the years at issue, the remaining interests in Partnership were owned by Franchisee's wife (E percent) and her irrevocable trust (F percent). Partnership's operating agreement provides for only one class of unit of ownership. Neither Franchisee's wife nor her trust are involved with Partnership's business operations and their status as limited partners for purposes of § 1402(a)(13) is not in dispute.

Franchisee's franchise agreements with Company require Franchisee to personally devote full time and best efforts work on the operation of the restaurants. Partnership's operating agreement provides that Franchisee is Partnership's Operating Manager, President, and Chief Executive Officer and shall conduct its day-to-day business affairs. In particular, Franchisee has authority to manage Partnership, make all decisions, and do anything reasonably necessary in light of its business and objectives. Franchisee's authority includes authority to: institute, prosecute, and defend any proceeding in Partnership's name; purchase, lease, and sell property; enter into contracts; lend money and invest Partnership funds; hire and fire Partnership's employees; establish pension plans; and hire accountants, investment advisors, and legal counsel on behalf of Partnership.

In his capacity as a partner, Franchisee directs the operations of Partnership, holds regular meetings and discussions with his management team and staff, makes strategic and succession planning decisions, makes investment management and planning decisions (e.g., acquisitions, sale transactions, and real estate activities), is involved in Company's regional board and conferences, and is involved in Company's national conferences and strategic planning. Franchisee's day-to-day activities for Partnership generally consist of handling emails and phone calls, store visits (when in town), management meetings, and staff meetings. Franchisee estimates that he worked for Partnership approximately G hours during each year at issue.

Franchisee states that he traveled out of state for approximately H months each year at issue, and estimates that he also spent approximately I hours during each year at issue in activities relating to other business organizations, charities, and community organizations.

Partnership employs over J individuals, many of whom have some level of management or supervisory responsibility. Pursuant to his authority under Partnership's Operating Agreement, Franchisee has appointed an executive management team consisting of financial and operations executive employees who do not have an ownership interest in Partnership, but have been given the responsibility of managing certain of Partnership's day-to-day business affairs, including making certain key management decisions.

Franchisee has ultimate responsibility for hiring, firing, and overseeing all Partnership's employees, including members of the executive management team.

In Year 2, Year 3, and Year 4, Partnership made guaranteed payments to Franchisee of $K, $L, and $M, respectively.

Partnership treated Franchisee as a limited partner for purposes of § 1402(a)(13), and included only the guaranteed payments in Franchisee's net earnings from self-employment, not his full distributive share. Partnership's position is that Franchisee's income from Partnership should be bifurcated for self-employment tax purposes between Franchisee's (1) income attributable to capital invested or the efforts of others, which is not subject to self-employment tax, and (2) compensation for services rendered, which is subject to self-employment tax. Partnership asserts that, as a retail operation, Partnership requires capital investment for buildings, equipment, working capital and employees, and states that, in the years at issue, it spent approximately $N in fixed asset additions. Partnership notes that Franchisee and Partnership have made significant capital outlays to acquire and maintain the restaurants, and argues that Partnership derives its income from the preparation and sale of food products by its J employees, not the personal services of Franchisee. Partnership asserts that the Franchisee has a reasonable expectation for a return on his investment beyond his compensation from Partnership. Partnership argues that Franchisee's guaranteed payments represent "reasonable compensation" for his services, and that Franchisee's earnings beyond his guaranteed payments were earnings which were basically of an investment nature. Partnership cites to *Brinks Gilson & Lione a Professional Corporation v. Commissioner*, T.C. Memo 2016-20, a case involving a corporation's deduction for compensation paid to employees who were also shareholders, for the propositions that Partnership's guaranteed payments to Franchisee are reasonable compensation for Franchisee's services, and that Franchisee's distributive share represents a reasonable return on the capital investments. Therefore, Partnership concludes that Franchisee is a limited partner for purposes of § 1402(a)(13) with respect to his distributive share.

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)(3) provides that there shall be excluded any gain or loss (A) which is considered as gain or loss from the sale or exchange of a capital asset, (B) from the cutting of timber, or the disposal of timber, coal, or iron ore, if § 631 applies to such gain or loss, or (C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither (i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor (ii) property held primarily for sale to customers in the ordinary course of the trade or business. Thus, while § 1402(a)(3) provides an exclusion from self-employment tax for certain gains or losses on sales of capital assets and other property, this exclusion does not apply to gains and losses from the sale of stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business. Rather, sales income from a capital-intensive business such as a restaurant or retail operation would not qualify for the exclusion in § 1402(a)(3) and, therefore, this income would be subject to self-employment tax unless another exclusion applies.

Section 1402(a)(13) provides another exclusion:

> 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."[1] 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 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).

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).

Individual partners who are not limited partners 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. The Tax Court decisions in *Cokes v. Commissioner*, 91 T.C. 222 (1988), *Methvin v. Commissioner*, T.C. Memo. 2015-81, and *Perry v. Commissioner*, T.C. Memo. 1994-215, all involved individuals who owned working interests in oil and gas joint ventures, but did not participate in the business operations. 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.

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[1] 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 have not been finalized.

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, noted the partners' small capital contributions, and found 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.

Based on its analysis of Kansas entity law, the ordinary meaning of the term "limited partner," and the legislative history and purpose of § 1402(a)(13), the *Renkemeyer* Court 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.

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.

The *Brinks* case cited by Partnership involved a corporation that conceded in a closing agreement that it made excessive compensation to its shareholder employees and that it should not have claimed deductions to the extent the compensation was excessive. The issue in the case was whether the corporation was liable for accuracy-related penalties on underpayments of tax as a result of claiming the deductions for the excessive compensation. The Tax Court applied the rules for determining a shareholder employee's reasonable compensation, under which shareholder employee's earnings must be appropriately balanced between reasonable compensation via wages and a return on invested capital via dividends. The Court determined that the petitioner corporation was subject to the accuracy related penalty because it did not have substantial authority for leaving its shareholder employees with no return on their invested capital.

As discussed above, a partner must include his distributive share of partnership income in calculating his net earnings from self-employment. Income from a food services business is part of a partner's distributive share under § 702(a)(8). Consequently, such income is included in calculating net earnings from self-employment, unless an exclusion applies. While § 1402(a)(3) excludes from self-employment tax certain gain and loss on dispositions of property, the exclusion does not apply to a restaurant or retail operation's sales of food or inventory. Thus, § 1402(a)(3) contemplates that a capital-intensive business such as a retail operation with stock in trade or inventory may generate income subject to self-employment tax. Because Partnership earns its income from food sales in the ordinary course of its trade or business, the exclusion in § 1402(a)(3) does not apply to Partnership's income. Therefore, unless Franchisee is a limited partner, Franchisee is subject to self-employment tax on all of the food sales

income, notwithstanding the capital investments made, the capital-intensive nature of the business, or the fact that Partnership has many employees.

Partnership is an LLC treated as a partnership for federal tax purposes, and has only three partners, two of which (Franchisee's wife and her trust) are not involved with Partnership's business. As described above, Partnership has taken the position that Franchisee is a limited partner for purposes of the exclusion in § 1402(a)(13). Franchisee is not a limited partner for purposes of § 1402(a)(13). As discussed above, the *Renkemeyer* Court reviewed the legislative history of § 1402(a)(13) and concluded that § 1402(a)(13) was intended to apply to those who "merely invested" rather than those who "actively participated" and "performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons)." *Renkemeyer,* 136 TC at 150. The *Renkemeyer* Court explained that "the interest of a limited partner in a limited partnership is generally akin to that of a passive investor." Id. at 147, 148. And as the *Riether* Court stated, limited partners are those who "lack management powers but enjoy immunity from liability for debts of the partnership." *Riether*, 919 F.Supp.2d 1140, at 1159, 1160. Here, Franchisee has sole authority over Partnership, and is the majority owner, Operating Manager, President, and Chief Executive Officer with ultimate authority over every employee and each aspect of the business. Even though Partnership has many employees, including several executive-level employees, Franchisee is the only partner of Partnership involved with the business and is not a mere investor, but rather actively participates in the partnership's operations and performs extensive executive and operational management services for Partnership in his capacity as a partner (i.e., acting in the manner of a self-employed person). Therefore, the income Franchisee earns through Partnership is not income of a mere passive investor that Congress sought to exclude from self-employment tax when it enacted the predecessor to § 1402(a)(13).

Partnership concedes that under the legislative history quoted above and the *Renkemeyer* opinion, "service partners in a service partnership acting in the manner of self-employer persons" are not limited partners. However, Partnership argues that a different analysis should apply to limited liability members which: (1) derive their income from the sale of products, (2) have made substantial capital investments, and (3) have delegated significant management responsibilities to executive-level employees. Partnership asserts that in these cases the IRS should apply "substance over form" principles to exclude from self-employment tax a reasonable return on capital invested.

Partnership interprets the legislative history quoted above to mean that § 1402(a)(13) applies to exclude a partner's reasonable return on capital investment in a capital-intensive LLC partnership, regardless of the extent of the partner's involvement with the partnership's business. In effect, Partnership interprets the sentence from the legislative history "This is to exclude for coverage purposes certain earnings which are basically of an investment nature" as instead meaning "This is to exclude for coverage purposes all earnings which constitute a reasonable return on capital invested in a

capital-intensive business." Essentially, Partnership argues that the self-employment tax rules for capital intensive businesses carried on by LLC partnerships are identical to the employment tax rules for corporate shareholder employees: only reasonable compensation is subject to employment tax. Under this analysis, Partnership argues that (1) Partnership's guaranteed payments to Franchisee are reasonable compensation for Franchisee's services, and (2) Franchisee's distributive share represents a reasonable return on capital investments in Partnership's business, and therefore Franchisee is not subject to self-employment tax on his distributive share. Partnership argues that it would be inconsistent with the IRS's position in the *Brinks* case for the IRS to assert that Franchisee is subject to self-employment tax on his distributive share from Partnership.

Partnership's arguments inappropriately conflate the separate statutory self-employment tax rules for partners and the statutory employment tax rules for corporate shareholder employees. Section 1402(a)(13) provides an exclusion for limited partners, not for a reasonable return on capital, and does not indicate that a partner's status as a limited partner depends on the presence of a guaranteed payment or the capital-intensive nature of the partnership's business.

Following the Court's analysis in *Riether*, Partnership cannot change the character of Franchisee's distributive shares by paying Franchisee guaranteed payments. Partnership is not a corporation and the "wage" and "reasonable compensation" rules which are applicable to corporations and were at issue in the *Brinks* case do not apply.

As discussed above, the *Renkemeyer* Court reviewed the legislative history and concluded that § 1402(a)(13) was intended to apply to those who "merely invested" rather than those who "actively participated" and "performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons)." *Renkemeyer,* 136 TC at 150 Although the *Renkemeyer* Court noted the partners' small capital contributions and service-generated income as factors influencing its decision that the partners in that case were not limited partners, *Renkemeyer* does not stand for the proposition that a capital-intensive partnership should be treated like a corporation for employment tax purposes. Instead, as the Tax Court has repeatedly held, partners who are not limited partners are subject to self-employment tax, even in cases involving capital-intensive oil and gas joint ventures where all of the work was performed by other parties. See *Cokes*, *Methvin*, and *Perry*. Under the *Renkemeyer* Court's interpretation of the legislative history, and consistent with the Court's holding in *Riether*, Franchisee is not a limited partner in Partnership within the meaning of § 1402(a)(13) and is subject to self-employment tax on his full distributive shares of Partnership's income described in § 702(a)(8).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[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 Elliot Rogers at or Benjamin Weaver at if you have any further questions.

Sincerely,

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