

## Tax Court Decision Subjects LLP Service Providers/Equity Partners to Self-Employment Tax

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In a decision issued February 9, the U.S. Tax Court ruled, in part, that the partners of a law firm established as a limited liability partnership (LLP) under state law were subject to Self-Employment Contributions Act (SECA) tax on their distributive share of LLP income received in respect of their services. In doing so, the court determined that the LLP partners could not avail themselves of the exemption from SECA for nonguaranteed service payments to “limited partners.” This ruling illustrates the potential risk for service provider limited partners and limited liability company members of assuming that state law entity and limited liability classifications alone shield them from being subject to SECA tax.

### Background

Generally, payments to service providers who are not classified as employees for federal payroll tax purposes are not subject to any payroll tax withholding or payment liability on the part of the payor. Instead, Section 1401 imposes SECA tax on “self-employment” income at the rate of 15.3%, a combination of a 12.4% old-age, survivors, and disability insurance (OASDI) tax and a 2.9% Medicare tax. The OASDI tax is only imposed on the first \$106,800 of “net earnings” (which allows for offsets to gross earnings for deductible expenses associated with the creation of the income) for 2011. Subject to certain exemption rules, self-employment earnings include income derived by an individual from any trade or business carried on by such individual plus his or her distributive share of partnership income or loss from any trade or business carried on by a partnership in which he or she is a partner. One of the exemption rules, included in Section 1402(a)(13) of the Internal Revenue Code, excludes from self-employment earnings “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” (emphasis added). Unfortunately, Congress failed to provide a definition for limited partner in the statute.

In order to resolve this definitional ambiguity, the U.S. Treasury released temporary regulations in 1997 under which partners with either authority to contract on behalf of the partnership or who participate in the partnership’s trade or business for more than 500 hours during the partnership’s taxable year could not be limited partners for Section 1402(a)(13) exemption purposes. In addition, no service partner in a service partnership could be a limited partner. This guidance created political shockwaves so extensive that Congress imposed a 12-month moratorium on Treasury’s ability to issue further guidance under Section 1402(a)(13). Since that time, Treasury has not provided guidance on the limited partner exemption from SECA tax.

Confronted with the dearth of authority on this issue, many tax practitioners have taken the position that all partners in a tax partnership, who are limited partners or limited liability company members under state law, are per se eligible for the Section 1402(a)(13) limited partner exemption. Others, although not required by law, have followed the guidance under the proposed regulations.

### ***Renkemeyer* Decision**

It was this definition of “limited partner” that was at issue before the Tax Court in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. No. 7 (2011). In that case, the Tax Court addressed an IRS challenge to both (1) the special allocation of the LLP’s (a law firm treated as a partnership for federal income tax purposes) distributive share of income to its partners and (2) the treatment of the LLP distributive share allocations of business income to its service partners (the law partners) as being exempt from SECA tax. After ruling in favor of the IRS on the allocation issue (the petitioner could not produce a partnership agreement supporting the challenged special partnership allocations), the court turned to the SECA tax issue.

The LLP partners argued that the limited partner exemption should apply because (1) the LLP organizational documents designated their interests as limited partnership interests and (2) they enjoyed limited liability under state law. The Tax Court disagreed, reaching the result that would have been required under the temporary regulations. Noting that Congress passed the limited partner exemption prior to the state law advent of LLPs and LLCs, the court reviewed the exemption’s legislative history and determined that the impetus for the exemption was not a limited partner’s individual protection from the partnership’s liabilities, but instead its status as a nonservice investment partner in a traditional limited partnership. In doing so, the court found that Congress did not intend for active service partners, such as the LLP partners, to be exempt from self-employment taxes. Specifically, the court referred to the partners’ minimal LLP capital contributions in exchange for their interests in LLP as indicating that the partners’ distributive share of income arose from the legal services performed on behalf of LLP and “not . . . as a return on the partners’ investments and . . . not [as] ‘earnings which are basically of an investment nature.’” (citing the Section 1402(a)(13) legislative history). Additionally, the *Renkemeyer* opinion hinted that the same rationale could be applied to prevent members of an LLC from qualifying as Section 1402(a)(13) limited partners.

### **Implications**

*Renkemeyer* demonstrates the hazards of assuming that state law entity and limited liability classifications should control for purposes of determining eligibility for the Section 1402(a)(13) SECA tax limited partner exemption. That is, there may be danger in taking the per se limited partner exemption position described above. Service providers to tax partnerships (including LLCs treated as tax partnerships) in which they are also equity partners should thus be wary of whether both their service-related payments and guaranteed partnership equity allocations would be considered self-employment income subject to SECA tax.

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