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Are Service Performing Partners of LPs, LLPs or LLCs Exempt From Self-Employment Taxes?

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The debate over the issue of whether self-employment taxes apply to distributions from limited liability entities, such as limited liability partnerships or limited liability companies, was reignited in *Renkemeyer v. Commissioner*, 136 T.C. No.7 (2011). In that case, the court held that the partners' distributive shares of the net business income of a law firm that was organized as a limited liability partnership (LLP) were subject to self-employment taxes and not subject to the exclusion for the distributive shares of limited partners. After *Renkemeyer*, where does the law stand?

Introduction and Background

Code section 1401 imposes a tax on self-employment income. With respect to partnerships, section 1402(a) defines the term "net earnings from self-employment" as including an individual's "distributive share (whether or not distributed) of income or loss described in code section 702(a)(8) from any trade or business carried on by a partnership" of which the individual is a member. Code section 1403(a)(13) provides a limitation for income allocated to a limited partner (LP) by providing that "there shall be excluded from the computation of a partner's self-employment income the distributive share of any item of income or loss of a LP, as such, other than guaranteed payments described in code 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."

The term "limited partner" (LP) is not defined in the statute or in the regulations. Until Renkemeyer, case law determined the status of a partner as a LP solely under the local law. If the partner was a limited partner under local law, then the partner's distributive share of partnership income was exempt under code section 1402(a)(13), regardless of how active the partner was in the partnership's business. On the other hand, if the partner was not a LP under local law, the partner's distributed share of partnership income was not excluded under code section 1402(a)(13), regardless of how passive the partner was. As a result, the status of partner as a limited partner was determined not on a functional basis, but merely on the basis of whether the partner was a LP under local partnership law.

Proposed Regulations

In 1997, the Internal Revenue Service (IRS) issued proposed regulations defining LP. Under the proposed regulations, an individual would be treated as a LP unless the individual had personal liability for debts of or claims against the partnership, had authority to contract for the partnership or participated in the partnership's trade or business for more than 500 hours a year. If the partnership was a service partnership, even if the LP did not meet the 500-hours-a-year threshold, the LP's distributive share of partnership income would not be excluded from self-employment income of the LP. In response to the proposed regulations, the Senate passed a nonbinding resolution providing that the proposed regulations were outside the scope of the Treasury's authority and that Congress should determine the law governing self-employment income of LPs. Ultimately, Congress imposed a 12-month moratorium stripping Treasury of its authority to issue guidance on the definition of LPs for self-employment tax purposes. Since the expiration of the moratorium, the proposed regulations have not been withdrawn or finalized. As a result, there is no guidance with respect to the definition of LP.

Renkemeyer – Facts

The Renkemeyer case involved a law firm, which consisted of three partners practicing law and an employee stock ownership plan (ESOP) as a fourth partner, which was formed as a general partnership with special limited liability under Kansas law. In 2004, most of the income of the partnership was allocated to the ESOP and no self-employment tax was paid on that income. In the subsequent year, the ESOP withdrew and the partnership was recapitalized with the individual partners receiving general managing-partner interests and investing-partner interests. The 2005 income was allocated among the partners, in accordance with the new partnership agreement. No self-employment taxes were paid on the partners' distributive shares of the income. Upon audit, the IRS reallocated the income for 2004 in accordance with the profit-and-loss (P&L) interests of the individual partners and determined that the partners' distributive shares of the law firm's net income for both 2004 and 2005 were subject to self-employment tax. Before the Tax Court, the partners argued that their interests were LP interests because they were designated as such in the organization documents and their liability was limited. Thus, their distributive shares of the law firm's income qualified for the exclusion from self-employment tax.

Renkemeyer – Decision

The court held that since the performance of legal services by the partners generated all of the income of the law firm, regardless of how the partners classified themselves, the distributive shares of the income of the law firm were subject to self-employment tax. Noting that the term LP had become obscured as a result of the complexity of partnerships, the court did not rely upon the definition of LP as one who is a LP under local law. On the basis of the legislative history, it found that a LP was meant to be someone earning income "of an investment nature"; that limited liability was not a factor in that determination; and Congress did not wish to exclude service-performing partners from liability for self-employment taxes.

The opinion comes very close to adopting the functional test of the proposed regulations. The court found that labeling a partner as a LP is not enough to be eligible for the exclusion from the self-employment tax; instead, the court found that the test should be whether the LP is actively participating in the business of the partnership and whether the LP's income from the partnership is predominately of an investment nature. Rather than merely holding, as other courts had done, that partners of a LLP are not LPs, the court used a functional test to make the determination. Under that test, members of limited liability companies who performed services would not be treated as LPs because their distributive shares of income would not be of an investment nature, but would be for services performed on behalf of the limited liability company.

IRS Guidance

IRS representatives have stated that taxpayers can rely upon the 1997 proposed regulations since they have not been withdrawn or finalized. However, because these statements from the IRS have been oral and therefore not in compliance with governing revenue procedure on written advice to taxpayers, they are not binding on the IRS.

Conclusion

While, given the facts, the result in *Renkemeyer* is not a surprise, the decision has caused confusion in the area. Rather than merely holding that a partner in a state law LLP is not a LP for purposes of the self-employment tax, the court adopted a functional test similar to the one in the proposed regulations, based on whether the partner is actively participating in the business of the partnership. To clear up the uncertainty that exists, it the IRS should either finalize or withdraw the proposed regulations.

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