NEW CASE SHOWS THE IRS GETTING "SIRIUS" ABOUT SECA TAXES AND LIMITED PARTNERS

HALE E. SHEPPARD

This article discusses a pending Tax Court case and the related chaos surrounding self-employment taxes on distributions to limited partners because of decades of inaction by Congress and the IRS.

What do you get when you combine a tax provision missing a key definition, no final tax regulations in over 45 years, an expansion of the types of state law entities treated as partnerships for federal tax purposes, partners hoping not to pay self-employment taxes, and the IRS aggressively challenging the tax exclusion for distributive shares to limited partners? Chaos.

This article explains the application of self-employment taxes, specifically Self-Employment Contributions Act ("SECA") taxes, to partnership distributions, studies the evolution of the laws, regulations, events, IRS rulings, and cases from 1950 to 2022 centered on the limited partner exception, and analyzes the pending Tax Court case, *Sirius Solutions, LLLP v. Commissioner*, which is poised to create important precedent regarding these matters.[1]

Overview of SECA taxes

Compensation earned by taxpayers for working is generally subject to employment taxes. When dealing with "employees," these taxes are comprised of several items, including federal income taxes and Federal Insurance Contributions Act ("FICA") taxes, consisting of Social Security taxes and Medicare taxes. However, in situations involving sole proprietors, independent contractors, and partners, SECA taxes substitute FICA taxes.[2] The SECA tax rate in 2020 was 15.3 percent of "net earnings from self-employment," which could represent a significant amount if a taxpayer is prospering.[3]

The term "net earnings from self-employment" generally means gross income derived by an individual from any trade or business carried on by such individual, minus certain business-related deductions, plus his distributive share of income from any partnership in which he is a partner.[4] A number of exceptions exist. Importantly for this article, Section 1402(a)(13) excludes from the definition of "net earnings from self-employment," and thus from SECA taxes, the distributive share of any income item to a "limited partner," as a limited partner, other than certain guaranteed payments.[5]

Evolution of uncertainty

Many people have written over the years about the relationship between SECA taxes and partner-

HALE E. SHEPPARD, B.S., M.A., J.D., LL.M., LL.M.T., is a shareholder in the tax controversy section of Chamberlain Hrdlicka. He specializes in tax audits, tax appeals, and Tax Court litigation. You can reach Hale by phone at 404.658.5441 or by email at hale.sheppard@chamberlainlaw.com.

ships.[6] This particular article is unique, however, in that it describes, in chronological order, the major events from 1950 through 2022 that have led to the current anarchy. One must read it to believe it.

SECA taxes start in 1950. Congress established the Social Security system in 1937. Originally, self-employed workers did not contribute to and thus were not eligible to receive benefits from the system. This changed in 1950 when Congress introduced SECA taxes.[7] Distributive shares to *all* partners, both general and limited, were initially subject to SECA taxes.[8]

Limited partner exception appears in 1977. Things changed when Congress developed a carve-out for limited partners about a quarter century later.

Statutory language. In 1977, Congress enacted the predecessor to Section 1402(a)(13), which was an exception from SECA taxes for certain "limited partners."[9] This critical provision states the following:

> [T]here 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.[10]

Legislative history.

Understanding why Congress created Section 1402(a)(13) is pivotal. The IRS and several courts have focused on the following portion of the legislative history from 1977:

> Under [the previous law enacted in 1950], 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 [introducing Section 1402(a)(13) in 1977] 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 [Social Security] coverage purposes certain earnings which are basically of an investment nature ...[11]

Other portions of the same legislative history raise the possibility of allocating income between SECA amounts and non-SECA amounts. The following excerpt from the key congressional report seemingly approves of income bifurcation:

> Distributive shares received as a general partner would continue to be covered [by SECA taxes]. Also, if a person is *both* a limited partner and a general partner in the same partnership, [only] the distributive share received as a general partner would continue to be covered [by SECA taxes].[12]

Perhaps the most critical insight from Congress came later in the same report. It clarifies the specific problem, and the perceived abuse, which Congress endeavored to solve by enacting Section 1402(a)(13):

> Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for Social Security benefits. In these situations, the investor in the limited partnership performs no services for the partnership and the Social Security coverage which results is, in fact, based on income from an investment. This situation is, of course, inconsistent with the basic principle of the Social Security program that [Social Security] benefits are designed to partially replace lost earnings from work.
>
> These advertisements and solicitations are directed mainly toward public [i.e., government] employees whose employment is covered by public retirement systems and not by Social Security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive Social Security credit in a year) will eventually gain a high return on the Social Security contributions. Many of those who invest in limited partnerships will qualify for minimum [Social Security] benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under Social Security for many years with low earnings. The costs of paying these heavily weighted benefits to limited partners must, of course, be bourne by all persons covered by the Social Security program. The advertising [for the sale of limited partnership interests] injures the Social Security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under Social Security, as well as those people without work income, who would like to be able to become insured under the Social Security program but cannot afford to invest in limited partnerships.[13]

A careful reading of the preceding legislative history reveals that Congress was concerned in 1977 that (i) unscrupulous persons were selling limited partner interests solely for purposes of allowing individuals who were otherwise ineligible for Social Security benefits to gain access to them; (ii) the limited partners were not investing in the normal sense of the word, not risking money with hopes of getting passive income in return; (iii) the limited partners were not paying significant SECA taxes because of the minimum distributive shares they received; (iv) the limited partners were obtaining unfairly large Social Security benefits to the detriment of all workers financing the system; (v) many government workers were participating in this improper scheme; and (vi) allowing abuse of the Social Security system would trigger widespread ill will.

Taxpayer motivations. Readers might ask themselves why anyone in their right mind would take proactive steps to expose themselves to SECA taxes. Well, it made sense decades ago because the SECA tax rate was low (it was 2.25 percent initially and only 7.9 percent in 1977). Individuals only planned to subject a small amount of income to SECA taxes, and the value of the Social Security benefits far outweighed the cost of the SECA taxes.[14]

Congressional solution. Congress implemented a solution designed to stop exploitation of the Social Security program. Namely, it introduced Section 1402(a)(13) in 1977. This provision generally excludes from the definition of "net earnings from self-employment," and thus from SECA taxes, the distributive share to a limited partner.

Times changed, but the rules did not. Congress originally created the exclusion in 1977 to halt people from improperly calling themselves limited partners with the goal of *subjecting* themselves to SECA taxes. Given the purpose of the exclusion, Congress logically intended to broadly define the term "limited partner" to ban as many people as possible from the Social Security program.

However, with the passage of years and the increase in SECA tax rates (it had reached 15.3 percent in 1990), the IRS noticed what it considered a different, unforeseen problem: people characterizing themselves as limited partners with the objective of *shielding t*hemselves from SECA taxes. The IRS, therefore, wanted to do an about-face and narrowly interpret the term limited partner to include as many people as possible in the Social Security program. The problem for the IRS, as highlighted throughout this article, is that Congress never legislatively defined the term limited partner in this context, and the IRS, for various reasons, never issued official guidance clarifying the meaning.

IRS introduces First Proposed Regulations in 1994. After chewing on the matter for about two decades, the IRS issued its first set of proposed regulations about Section 1402(a)(13) in 1994 ("First Proposed Regulations").[15] They contained rules for treatment of limited partners in partnerships, as well as members of limited liability companies ("LLCs") treated as partnerships.[16]

Under the First Proposed Regulations, the amount subject to SECA taxes generally included an individual's distributive share from any trade or business carried on by an LLC of which the individual was a member.[17] They went on to explain that a member of an LLC would be treated as a "limited partner" for purposes of Section 1402(a)(13), thereby not obligated to pay SECA taxes, if the member met two criteria. First, the member could not be a manager of the LLC.[18] Second, the pertinent LLC could have been formed as a limited partnership instead of an LLC, and the member

[1] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20.

[2] Section 1401(a) and (b); Revenue Ruling 69-184 (explaining that "remuneration received by a partner from the partnerships is not 'wages' with respect to 'employment' and therefore not subject to FICA, federal income tax withholding or other employment taxes").

[3] Section 1401(a) and (b).

[4] Section 1402(a).

[5] *Ibid.*, (13).

[6] *See* Dilley, P.E, "Breaking the glass slipper – Reflections on the self-employment tax," *The Tax Lawyer* 54, no. 1 (2000); Banoff, S.I., "Renkemeyer compounds the confusion in characterizing limited and general partners – Part I," *Journal of Taxation* 115, no. 6 (2011); Fritz, T.E., "Flowthough entities and the self-employment tax: Is it time for a uniform standard?" *Virginia Tax Review* 17 (1998); Marquis, J.R., "Current status of limited liability companies and the self-employment income tax," *Michigan Bar Journal* 77 (May 1998); Koski, T.R., "Self-employment tax and limited liability companies: When are LLC earnings subject to self-employment taxes?" *Taxes – The Tax Magazine* 83, no. 9 (2005); Koski, T.R., "Partners of law firm organized as LLP held liable for self-employment tax on distributive share of earnings – Uncertainty on how SE tax applies to LLPs and LLCs remains," *Taxes – The Tax Magazine* 89, no. 8 (2011); Koski, T.R., "Surgeon escapes self-employment tax on distributive share of LLC income from surgery center – Application of SE tax to LLCs remains unclear," *Taxes – The Tax Magazine* 95, no. 8 (2017); Trivedi, S., "Renkemeyer facts limit decision's scope, practitioners say," *Tax Notes* 133 (Oct 31, 2011); Megaard, S.L. and Megaard, M.M., "Reducing self-employment taxes on owners of LLPs and LLCs after Renkemeyer," *Practical Tax Strategies* 87 (Aug 2011); Elliott, A.S., "Tax Court decision could reignite debate over partnerships and employment taxes," *Tax Notes* 130 (Mar 14, 2011); Karlinsky, S., "Self-employment taxes and PALs: The case of LLCs), *Tax Notes* 132 (Sept 26, 2011); Winchester, R., "The gap in the employment tax gap," *Stanford Law & Policy Review* 20, no. 1 (2009); Culpepper, D.C., Holo, S., Keatinge, R.R., Lenz, T.C., Schippel, B.A., Shapack, R.A., and Yearout, T.E. "Self-employment taxes and passthrough entities: Where are we now?" *Tax Notes* (Oct. 10, 2005) (special report); Erdman, L.E., "Reinterpreting the limited partner exclusion to maximize labor income in the self-employment tax base," *Washington and Lee Law Review* 70, no. 4 (2013).

[7] "The taxation of capital and labor through the self-employment tax," Congressional Budget Office (Sept 2012): 1.

could have qualified as a limited partner instead of a member.[19]

What was the IRS trying to accomplish with the second criteria? The Preamble to the First Proposed Regulations supplied some clarity. It explained that state laws prohibited taxpayers from conducting certain activities through partnerships, and the IRS did not want to allow a business operating as an LLC to obtain a result for SECA tax purposes that it could not otherwise achieve functioning as a limited partnership.[20] The Preamble noted that a limited partner could potentially become liable for the debts and other obligations of a limited partnership if he were to participate in the management or control of the business. Therefore, the IRS aimed to ensure that individuals who got involved in management or control of an entity would be treated similarly for purposes of SECA taxes.[21]

Definitions mattered, of course. The First Proposed Regulations described an LLC as an entity that was classified as a partnership for federal tax purposes and featured limited liability of its members for the obligations of the entity under applicable state law.[22] Another important term was "manager." The First Proposed Regulations indicated that a manager was a person who, either alone or together with others, had continuing and exclusive authority to make management decisions for the LLC.[23] It then explained that, if an LLC did not elect or designate a manager pursuant to state law or its operating agreement, then every member would be treated as a manager in this context.[24]

IRS introduces Second Proposed Regulations in 1997. After reviewing written comments from the public about the First Proposed Regulations and holding a hearing, the IRS decided to revamp its approach. In 1997, it withdrew the First Proposed Regulations and released a new set ("Second Proposed Regulations").[25] This time, the IRS provided guidance covering *all* entities classified as partnerships for federal tax purposes, not just LLCs. The updated rules arguably encompassed limited partnerships, LLCs, limited liability partnerships ("LLPs"), limited liability limited partnerships ("LLLPs"), and other entities that had emerged since Congress introduced the limited partnership exception to SECA taxes 20 years earlier, back in 1977.[26]

New definition of limited partner. The Second Proposed Regulations maintained the exception in Section 1402(a)(13), which provides that limited partners ordinarily are not exposed to SECA taxes on their distributive shares.[27] However, they changed the definition of "limited partner." The Second Proposed Regulations stated that an individual was *presumed* to be a limited partner, unless (i) he was personally liable for the debts or other claims against the partnership based on his status as a partner, or (ii) he had authority under state law to engage in contracts for the partnership, or (iii) he participated in the partnership's business more than 500 hours during a year.[28]

Two special rules. The Second Proposed Regulations featured two special rules, both of which were designed to relieve from SECA taxes "amounts that are demonstrably returns on capital invested in the partnership."[29]

An individual holding *just* one class of interest in a partnership, who was not classified as a limited partner solely because he participated in the trade or business of the partnership more than 500 hours during a year, would nevertheless qualify as a limited partner if, immediately after the individual acquired his interest, (i) limited partners owned a substantial and continuing interest in the relevant class, and (ii) the individual's rights and obligations with respect to such class were identical to those of other limited partners.[30]

An individual holding *more* than one class of interest in a partnership, who was not already treated as a limited partner, would be considered a limited partner if, immediately after he acquired his interest, (i) limited partners owned a substantial and continuing interest of the specific classes, and (ii) his rights and obligations with respect to such classes were identical to those of other limited partners.[31]

Service partners in service partnerships. The Second Proposed Regulations indicated that an individual who is a "service partner" in a "service partnership" would *not be a limited partner*.[32] For these purposes, the term "service partner" meant a partner who provided services to a partnership or on behalf of a partnership's trade or business.[33] A "service partnership," meanwhile, was a partnership substantially all of whose activities involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[34]

IRS rationales. The Preamble to the Second Proposed Regulations explained that the IRS wanted the same standards to apply to owners of limited partnerships and owners of other entities treated as partnerships, such as LLCs. To achieve the desired uniformity, the IRS adopted a method that looked to the relationship between the individual, the partnership, and the partnership's business.[35]

The IRS further explained that it decided to use "functional tests" to ensure that different individuals, owning interests in similar entities formed under different state laws, would be treated the same.[36] It then noted that "functional tests" were necessary because of the proliferation of new types of business entities since Section 1402(a)(13) was enacted in 1977 and because of the evolution of limited partnership statutes in various states. Specifically, the IRS observed that state laws back in 1977 ordinarily prohibited limited partners from participating in the business of the partnership, but that had changed. Thus, even in situations involving a limited partnership formed under state law, the IRS supposedly needs to rely on a "functional approach" to ensure that the SECA tax consequences are similar for all individuals, regardless of the state in which the relevant partnership was organized.[37]

Lastly, the Preamble underscored that whether state law characterized an individual as a "limited partner" was "not determinative" for purposes of the Second Proposed Regulations.[38]

Congress imposes a moratorium in 1997. Congress stopped the IRS in its proverbial tracks in 1997 by enacting a law expressly prohibiting the IRS from finalizing the Second Proposed Regulations, at least temporarily. The law stated that "[n]o temporary or final regulation with respect to the definition of limited partner under Section 1402(a)(13).... may be issued or made effective before July 1, 1998."[39] This essentially created a moratorium on regulations for about 18 months. If that were not enough, Congress suggested in the legislative history, in a segment labeled "Sense of the Senate," that the IRS should withdraw the Second Proposed Regulations and that "Congress should determine the tax law governing self-employment income."[40]

In summary, Congress halted the IRS in 1997, declaring that only the legislative branch (i.e., Congress), and not an agency of the executive branch (i.e., the IRS), had authority to create law regarding SECA taxes and the definition of limited partner.

Key administrative rulings and court cases.

Section 1402(a)(13) was enacted more than four decades ago, in 1977, yet relatively few IRS rulings and court cases have substantively addressed this critical provision. This article examines some key ones below.

Two cases involving working interests. The Tax Court wrestled with two cases involving taxpayers who purchased working interests in oil and gas wells, considered them an investment, did not participate in the activity, and reported the resulting income on their Forms 1040 (U.S. Individual Income Tax Returns), but did not pay SECA taxes on such amounts.

Johnson v.Commissioner.

In the first case, *Johnson v. Commissioner*, the taxpayer owned working interests in several oil

[8] T.D. 7333 (Dec 19, 1974); Treas. Reg. Section 1.1402(a)-2(d).

[9] Social Security Amendments of 1977, Public Law No. 95-216, Section 313(b).

[10] Section 1402(a)(13) (emphasis added).

[11] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct 12, 1977): 11.

[12] *Ibid.*, p. 40. (Emphasis added.)

[13] *Op. cit.* note 11, pp. 40–41.

[14] *Op. cit.* note 6 Erdman. (Explaining that the SECA tax rate was merely 7.9 percent and it applied only to the first $16,500 of net earnings.)

[15] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).

[16] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18 (Dec. 29, 1994).

[17] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(a) (Dec. 29, 1994).

[18] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(b)(1) (Dec. 29, 1994).

[19] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(b)(2) (Dec. 29, 1994).

[20] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18 (Dec. 29, 1994). Preamble – Explanation of Provisions.

[21] *Ibid.*

[22] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(c)(1) (Dec. 29, 1994).

[23] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(c)(3) (Dec. 29, 1994).

[24] *Ibid.*

[25] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.

[26] *Ibid.* (REG-209824-96 stating that "[t]hese proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity.")

[27] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(g).

[28] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(2).

[29] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

and gas properties in 1987.[41] The taxpayer had limited knowledge about mineral extraction, did not participate in the operations, and was "an inactive investor." She reported the income from the working interests on her Form 1040, but she did not pay SECA taxes.

The IRS audited the taxpayer and ultimately issued a Notice of Deficiency claiming that (i) her working interests constituted carrying on a trade or business, either as a partner or through an agent, and (ii) she should have paid SECA taxes on the income distributed to her from such business. The taxpayer disputed the IRS's allegations by filing a Petition with the Tax Court. She argued that the working interests were "merely investments" and her lack of activity indicated that she was not engaged in any business.

The Tax Court held in favor of the IRS. It explained that the definition of "partnership" is quite broad, encompassing syndicates, groups, pools, joint ventures, and other non-corporation organizations through which any business, operation, or venture is carried out. After reviewing the standard operating agreement that the taxpayer signed, the Tax Court determined that the various owners of working interests, including the taxpayer, created a pool or joint venture. Because a pool or joint venture is considered a partnership for federal tax purposes, the income that the taxpayer received is a distributive share from a partnership. Therefore, the Tax Court concluded, the taxpayer should pay SECA taxes.

The taxpayer countered that, even if she were deemed to be a partner in a partnership, she should still be free from SECA taxes because she was a limited partner under Section 1402(a)(13). The Tax Court did not challenge the taxpayer's minimal role, nor did it question the existence of the limited partner exception. However, the Tax Court emphasized that the taxpayer had failed to follow the requisite formalities. It summarized the conundrum as follows: "The short answer to this contention is that [the taxpayer] is bound by the form in which she cast her transaction" and her "argument is not persuasive because she and the other working interest owners did not take the necessary steps to comply with Texas law."[42] In other words, the Tax Court announced that while taxpayers can form a general partnership informally, they must jump through all the proverbial hoops to create a limited partnership under state law.

Perry v. Commissioner.

The second case, *Perry v. Commissioner*, featured nearly identical facts, legal issues, and conclusions. The Tax Court held that the taxpayer was not a limited partner because "state law requires that certain formalities be observed to create a limited partnership [and] there is no evidence of such formalities having been observed by the owners of the interests in the wells."[43]

Three private letter rulings about entity conversions. The IRS issued three private letter rulings ("PLRs") addressing various tax issues triggered by converting a general partnership into an LLC, PLR 9432018, PLR 9452024, and PLR 9525058. The first vaguely stated that the entity performed professional services; the second involved a group of doctors running a medical practice; and the third addressed several attorneys practicing law together. All the individuals, who were members in LLCs, actively engaged in their respective businesses.

The IRS concluded in all three instances that the new entities were partnerships for federal tax purposes. It also determined that the distributive shares received by the members would not be exempt from SECA taxes under the limited partner exception found in Section 1402(a)(13). The IRS's reasoning for this second conclusion was sparse, with only PLR 9432018 providing any specifics at all. It stated that the LLC was not a limited partnership, the members of the LLC were not limited partners (although they might be treated as such in certain contexts), and the members engaged in the daily activities of and performed substantial services for the LLC. Accordingly, the income allocated to each member of the LLC constituted "net earnings from self-employment" and should be subject to SECA taxes.[44]

Norwood v. Commissioner. The sole issue in *Norwood v. Commissioner* was whether the taxpayer was liable for SECA taxes on a distribution from a partnership.[45]

The taxpayer was a general partner in a medical supply company, owning nearly 51 percent of the interests. He worked diligently, on a full-time basis, during the first few years. His participation waned after that. Indeed, once the staff could operate the business without him, he essentially stopped working. His activities were reduced to making periodic appearances and being consulted on major decisions. In 1995, the taxpayer received a distributive share, reported it on his Form 1040, and paid the corresponding income taxes. He did not pay SECA taxes, though, which the IRS disliked. The fight ended up in Tax Court.

The taxpayer argued that his role in the company was minimal and passive during 1995, such that he should be shielded from SECA taxes by the limited partner exception in Section 1402(a)(13). The IRS suggested that whether the taxpayer was active or passive was irrelevant because he was a general partner, not a limited one.

The Tax Court sided with the IRS, explaining that "[t]he passive activity rules under Section 469 have no application in this case," the taxpayer's "lack of participation in or control over the operations of [the company] does not turn his general partnership interest into a limited partnership interest," and "a limited partnership must be created in the form prescribed by state law."[46]

Renkemeyer, Campbell & Weaver, LLP v. Commissioner. The taxpayers in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner* formed an LLP under Kansas law to operate their law practice ("Law Firm").[47] The Law Firm had three individual partners and one corporate partner in 2004. The Law Firm filed a timely Form 1065 for 2004, showing revenues primarily generated by the performance of legal services. Such revenues were distributed to the individual partners, not reported as "net earnings from self-employment" by the Law Firm, and thus not subjected to SECA taxes at the partner level.

The Law Firm amended its agreement to eliminate the corporate partner starting in 2005, to create two classes of ownership interests (i.e., General Managing Partner Interests and Investment Partner Interests), and to provide for equal allocation of distributive shares. Each of the three individual partners held both types of interests in the Law Firm and had equal authority. The Law Firm made distributions to the individual partners in 2005, who, again, did not pay SECA taxes on such amounts.

The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares in 2004 and 2005 as "net earnings from self-employment," not protected by the limited partner exception in Section 1402(a)(13), and thus subject to SECA taxes.

The Law Firm challenged the IRS in Tax Court. The Law Firm argued that its three partners, who were partners in an LLP formed under Kansas law, should be treated as limited partners under Section 1402(a)(13) because (i) their interests are specifically called limited partner interests in the Law Firm's organizational documents, and (ii) the partners each had limited liability under Kansas law.

The Tax Court disagreed with the Law Firm. It began by explaining the major differences between general partners and limited partners, in terms of management power and personal liability, concluding that a limited partner interest "is generally akin to that of a passive investor."[48] The Tax Court indicated that an LLP in Kansas is a different beast; it is essentially a *general* partnership that affords limited liability protection to all partners. The Tax Court went on to explain that the predecessor to Section 1402(a)(13), which used the phrase "limited partner," was enacted before LLPs and other modern entity forms came into exis-

[30] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(4). (The Preamble states that this rule permits an individual to bifurcate his distributive share by disregarding guaranteed payments for services. It warns, though, that such bifurcation is tolerated only to the extent that the individual's distributive share is the same as that of partners who qualify as limited partners under the new definition and who own a substantial interest in the partnership. *See* note 29.)

[31] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(3).

[32] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(5).

[33] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(i).

[34] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(ii).

[35] *Op. cit.* note 29.

[36] *Ibid.*

[37] *Op. cit.* note 29.

[38] *Ibid.*

[39] Taxpayer Relief Act of 1997, Public Law 105-34, Section 935 (Aug. 5, 1997).

[40] U.S. House of Representatives. Taxpayer Relief Act of 1997, Conference Report, 105th Congress, 1st Session, Report 105-220 (July 30, 1997): 765.

[41] *Johnson v. Commissioner*, T.C. Memo 1990-461.

[42] *Ibid.*

[43] *Perry v. United States*, T.C. Memo 1994-215.

[44] *Ibid.*

[45] *Norwood v. Commissioner*, T.C. Memo 2000-84.

[46] *Ibid.*

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

[48] *Ibid.*, p. 147.

[49] *Op. cit.* note 44, p. 150. (Citing the Social Security Amendments of 1977, Public Law 95-216, Section 313(b).)

[50] *Ibid.*, p. 150.

[51] *Op. cit.* note 44, p. 150.

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

[53] *Ibid.*

tence. It then recognized that the IRS attempted to address this issue many years ago, in 1997, by issuing the Second Proposed Regulations, but Congress prevented the IRS from finalizing them.

Without any additional guidance since then, either from Congress or the IRS, the Tax Court indicated that it must engage in an exercise of statutory interpretation to determine what, exactly, Congress meant when it used the term limited partner in the context of SECA taxes and Section 1402(a)(13). The Tax Court looked to just one small portion of the legislative history, which stated the following:

> The bill would exclude from [SECA taxes] 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 [SECA tax] purposes certain earnings which are basically of an investment nature.[49]

The Tax Court believed that this "insight" showed that the intent of Congress was to ensure that individuals who merely invested in a partnership and did not actively participate in its business operations would not receive credits toward Social Security coverage. It went on to explain that the legislative history does not support the notion that Congress contemplated excluding partners who performed services for a partnership, in their capacity as partners, from liability for SECA taxes.[50]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount for their partnership interests, and the distributive shares that they received during the relevant years were not, to cite the legislative history, "earnings which are basically of an investment nature." Accordingly, the Tax Court concluded that the partners had to pay SECA taxes on their distributive shares and the exception under Section 1402(a)(13) did not apply.[51]

Riether v. United States. The key issue in *Riether v. United States* was whether taxpayers must treat the distributive shares that they received from an LLC formed in New Mexico as income subject to SECA taxes. The taxpayers, husband and wife, owned the LLC.[52] The husband worked as a radiologist, providing medical services through the LLC.

It appears that the taxpayers tried to apportion their income from the LLC. They reported part as wages on Forms W-2 (Wage & Income Statement), and thus were subject to income taxes, FICA, etc. They reported the remainder as passive income not subject to SECA taxes.[53] The IRS audited the taxpayers, disagreed with the income bifurcation, and determined that the remainder from the LLC was subject to SECA taxes.

The District Court discussed the entity-classification rules and the fact that the LLC did not elect to be treated as a corporation, such that it was a partnership by default for federal tax purposes. The District Court pointed out that the only argument raised by the taxpayers was that they received a Form W-2 from the LLC as employees, and since they were employees, they were not self-employed. The District Court found this position "unpersuasive."

Citing to Revenue Ruling 69-184, the District Court said that the taxpayers should have treated *all* their income from the LLC as self-employment income because "members of a partnership are not employees of the partnership" for purposes of self-employment taxes. The District Court said that the taxpayers were members in an LLC, not partners in a partnership. Moreover, even if the relevant entity were a partnership, the taxpayers did not resemble limited partners, who lack management powers and are not liable for debts of the partnership. The District Court thus concluded that "whether the [taxpayers] were active or passive in the production of the LLC's earnings, those earnings were self-employment income."[54]

Howell v. Commissioner. The sole issue in *Howell v. Commissioner* was whether the taxpayer was liable for SECA taxes on payments that she received from an LLC formed in California.[55]

The husband of the taxpayer invented the concept that led to the formation of the LLC. Nevertheless, the husband decided to make his wife, the taxpayer, the primary member in the LLC because she had a better credit history. This superior credit rating would help the LLC in obtaining loans, credit cards, favorable interest rates, etc.

The taxpayer held a 60 percent interest in the LLC. The LLC entered into a Management Agreement with the husband, which delegated to him total and exclusive control of all management and operations of the LLC.

The LLC was treated as a partnership for federal tax purposes and filed a Form 1065 each year. It characterized certain amounts directed to the taxpayer as "guaranteed payments" on its Forms 1065, claiming the related deduction. The taxpayer, by contrast, filed her Forms 1040 characterizing the same income as a distributive share, passive in nature, and not subject to SECA taxes.

The IRS started an audit of the LLC, which soon broadened to cover the taxpayer, too. The IRS eventually issued a Notice of Deficiency. The taxpayer contended that none of the amounts received from the LLC should be subject to SECA taxes because the LLC mistakenly characterized some amounts as guaranteed payments on its Forms 1065, and she was a limited partner and thus exempt from SECA taxes under Section 1402(a)(13).

The IRS countered that the taxpayer previously admitted that certain amounts were guaranteed payments by labeling them as such on Forms 1065 filed by the LLC and she cannot disavow her original reporting position only after being caught by the IRS. The IRS further argued that the taxpayer was an active participant in the LLC, and such participation precluded her from enjoying the exclusion from SECA taxes for limited partners.

The Tax Court explained the general rule in Section 1402, the exception for limited partners, and the fact that the key term is not defined. Next, the Tax Court summarized the earlier holding and reasoning in *Renkemeyer*, emphasizing that the taxpayers in that case were not limited partners because their distributive shares arose from legal services that they performed for their law firm, and not from a passive return on investment.

The Tax Court then went through the two main arguments raised by the IRS. First, the Tax Court held that the taxpayer could not disavow, after the fact, the previous classification of certain amounts as "guaranteed payments." It pointed out that the taxpayer officially controlled the LLC, provided the tax-related data to the accountant, served as the Tax Matters Partner of the LLC, signed the Forms 1065, and only attempted to change the character of the income after the IRS started the audit and raised the SECA tax issues.

With respect to the limited partner argument, the Tax Court underscored that, according to the operating agreement for the LLC, the taxpayer contributed intellectual property, a business plan, and organizational design. She also executed the Management Agreement between her husband and the LLC. In addition, she testified that she provided marketing advice, implemented sales strategies, served as Tax Matters Partner, and used her personal credit card to purchase equipment for the LLC. Based on this, the Tax Court held that the taxpayer performed services for the LLC and was not merely a passive investor. Accordingly, the amounts she received constituted a distributive share subject to SECA taxes because the taxpayer was not a limited partner.

Chief Counsel Advice 201436409. The main facts in Chief Counsel Advice 201436409 are as follows.[56] The "Management Company" was an LLC treated as a partnership for federal tax purposes. It was formed as successor to an S corporation that previously served as an investment manager to various funds. The Management Company had full authority to manage and control the business of each fund, conducted market research, and implemented trading activity. The Management Company's

[54] *Op. cit.* note 52.

[55] *Howell v. Commissioner*, T.C. Memo 2012-281.

[56] Chief Counsel Advice 201436409.

[57] Chief Counsel Advice 201640014.

[58] *Ibid.*

[59] *Hardy v. Commissioner*, T.C. Memo 2017-16.

[60] *Castigliola v. Commissioner*, T.C. Memo 2017-62.

[61] *Ibid*.

[62] *Joseph v. Commissioner*, T.C. Memo 2020-65.

[63] *Ibid*.

[64] "Large business and international active campaigns," IRS. Available at: *www.irs.gov/businesses/corporations/lbi-active-campaigns.*

[65] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners (Feb 13, 2019): 10.

[66] *Ibid.*, p. 3.

[67] *Op. cit.* note 58, p. 13.

[68] U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service. 2015-2016 Priority Guidance Plan (July 31, 2015): 11.

[69] U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service. 2019-2020 Priority Guidance Plan – Fourth Quarter Update (Sept. 2, 2020).

[70] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021).

[71] *Ibid.*, p. 65.

[72] *Op. cit.* note 63, pp. 66–67. (Note the incongruity here: The IRS states in its recent Concept Unit that the SECA tax rules in Section 1402(a)(13) and the passive activity loss-limitation rules in Section 469 are completely unrelated, whereas the Biden Administration is taking the opposite approach in the Green Book, encouraging Congress to pass laws expressly stating that the two sets of rules should be inextricably linked.)

[73] Taylor, K.R., "Clarity regarding 'limited partner' under SECA remains elusive," *Tax Notes Today Federal* 112, no. 2 (June 11, 2021).

[74] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20. (The facts, arguments, and issues described in this article derive from the following sources: Notice of Final Partnership Administrative Adjustment dated June 12, 2020; Petition filed September 3, 2020; Answer filed November 11, 2020; Joint Motion for Continuance filed March 8, 2021; First Stipula-

primary source of income derived from management fees paid by each of the funds.

Several individuals were partners in the Management Company. They worked on a full-time basis, providing a wide range of investment-related services. The partners each held "units" in the Management Company, pursuant to which they received a distributive share.

It appears that the Management Company bifurcated the payments to the individual partners, classifying certain amounts as guaranteed payments and subjecting them to SECA tax, and classifying the majority as payments to limited partners exempt from SECA tax under Section 1402(a)(13). The Management Company reasoned that it had the same role as the S corporation that it succeeded, such that it was entitled to continue following the same "reasonable compensation" principles applicable to S corporations.

The IRS generally explained that Section 1402(a)(13) was enacted in 1977 before modern business forms, like LLCs, were common, suggested that Revised Uniform Limited Partnership Act indicates that a limited partner loses his status if he participates in control of the business, and summarized the Tax Court's holdings in *Renkemeyer and Riether*.

The IRS then turned to the facts at hand. It indicated that the partners of the Management Company performed extensive services in their capacity as partners and generated essentially all the income for the entity. Accordingly, such income "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 Section 1402(a)(13)." The IRS also opined that, although the partners paid more than a nominal amount for their units in the Management Company, the income they received was not passive. The IRS further warned, based on the holding in *Riether,* that taxpayers, like the Management Company, cannot unilaterally change the character of distributive shares by simply labeling a portion as guaranteed payments. Finally, the IRS concluded that the Management Company was an LLC, not an S corporation, such that it cannot rely on the "reasonable compensation" rules when distributing payments to its members.

Chief Counsel Advice 201640014. The Franchisee in Chief Counsel Advice 201640014 was the majority owner of an LLC, which was treated as a partnership for federal tax purposes.[57] The LLC owned and operated various chain restaurants, deriving most of its income from food sales.

The agreements between the Franchisee and Franchisor mandated that the Franchisee personally devote full-time and best efforts to operating the restaurants. Similarly, the operating agreement for the LLC (i) named the Franchisee as President, Chief Executive Officer, and Manager, (ii) indicated that he would conduct all business affairs, and (iii) granted him authority to make all major decisions, participate in legal proceedings, enter into real property contracts, loan money, invest, oversee employees, handle correspondence, establish pension plans, appoint others to act as supervisors, hire outside professionals, and more.

The LLC bifurcated the amounts it paid to the Franchisee each year. Certain amounts were treated as guaranteed payments, similar to reasonable compensation for services provided by the Franchisee, and subject to SECA taxes. Other amounts were characterized as passive income, attributable to return on his capital investment or the efforts of others, and not subject to SECA taxes. Regarding the second category, the LLC believed that the Franchisee was entitled to certain passive income thanks to the significant cash capital contributions he made, which were deployed to buy buildings and equipment, make improvements, hire employees, and more.

In addressing the limited partner exception issue, the IRS pointed out the following: (i) the Franchisee had sole authority over the LLC; (ii) he was the President, Chief Executive Officer and Manager; (iii) although the LLC had several executive-level employees, he was the only active member of the LLC; and (iv) he participated in the LLC's operations and management in his capacity as a member and was not a mere investor. Consequently, the IRS determined that the Franchisee could not benefit from the limited partner exception in Section 1402(a)(13).

The LLC conceded that, pursuant to the legislative history, service partners like the Franchisee generally are not limited partners. However, the LLC argued that it was distinct because it derived income from the sale of *products* instead of services, the Franchisee made significant capital contributions to the LLC, and the Franchisee delegated most management responsibilities to others. The LLC urged the IRS to apply substance-over-form principles to allow a portion of the distributive share to the Franchisee to be treated as passive return on investment.

The IRS rejected this suggestion, indicating that the LLC was confusing the SECA tax rules for partners with the employment tax rules for corporate shareholder employees. In short, the IRS stated that the LLC "is not a corporation and the wage and reasonable compensation rules which are applicable to corporations... do not apply."[58] The IRS went on to explain that, although the Tax Court in *Renkemeyer* identified the small capital contributions by the partners as one of the factors in its decision that the taxpayers were not limited partners, that case does not stand for the idea that a capital-intensive partnership should be treated like a corporation for employment tax purposes.

Hardy v. Commissioner.

Hardy v. Commissioner is a rarity in that the taxpayer prevailed on the limited partner issue.[59] The taxpayer in that case was a plastic surgeon who operated a medical practice through one LLC that he wholly owned. Surgical procedures generally have three fee components: a fee for the doctor, a fee for the anesthesiologist, and a fee for the surgical facility.

The taxpayer performed medical procedures in various facilities, including Missoula Bone & Joint Surgery Center, LLC ("MBJ"). The taxpayer held a minority interest in MBJ, but he never managed it, had day-to-day responsibilities, provided input for operational decisions, or got involved with personnel matters. The taxpayer only performed surgeries at the MBJ facility about once a week, and he received a distribution from MBJ, regardless of how many surgeries he did there.

The taxpayer reported passive income on his Form 1040 from MBJ during the relevant years, thus acknowledging that he was not "materially participating" for purposes of Section 469. The taxpayer did not, however, claim that he was entitled to the limited partner exception to SECA taxes under Section 1402(a)(13). Instead, he reported ordinary income from MBJ and paid the related SECA taxes.

The IRS audited. Among other things, it took the position that the income from MBJ was *not* passive, such that it could not be offset by a passive loss carryover from an earlier year. The taxpayer ultimately took his dispute to the Tax Court. One point of contention was whether the taxpayer should have paid SECA taxes on the distributions he received from MBJ. The taxpayer suggested to the Tax Court that he never should have paid those in the first place, and the IRS owed him a refund.

The Tax Court determined that the taxpayer did not materially participate in the activities of MBJ, such that the income flowing to him from MBJ was passive for purposes of Section 469. The Tax Court then turned to the related issue; that is, whether the income from MBJ was exempt from SECA taxes under Section 1402(a)(13) because the taxpayer was a limited partner.

The IRS argued that the taxpayer was not a limited partner in MBJ because he performed certain procedures at the surgical center operated by MBJ. The Tax Court rejected that contention. It acknowledged the holding in *Renkemeyer*, as well as the discussion in that case about the pertinent legislative history. However, the Tax Court pointed out that (i) the taxpayer was "an investor" in MBJ, (ii) he used the surgical facility only 10 percent of the time, (iii) he was not involved in the business operations of MBJ, and (iv) the patients paid MBJ for use

tion of Facts filed June 2, 2021; Motion for Summary Judgment filed June 4, 2021; Brief in Support of Motion for Summary Judgment filed June 4, 2021; Reply in Support of Petitioner's Motion for Summary Judgment and to Petitioner's Brief in Support of Motion for Summary Judgment filed August 13, 2021; Sur-Reply in Opposition of Petitioner's Motion for Summary Judgment and Petitioner's Brief in Support of Motion for Summary Judgment filed September 13, 2021; First Supplemental Stipulation of Facts filed December 3, 2021; and Respondent's Response and Brief in Opposition to Petitioner's Motion for Summary Judgment and to Petitioner's Brief in Support of Motion for Summary Judgment filed December 16, 2021.)

[75] IRC Section 1402(a)(13).

[76] *Ibid.*

[77] *Op. cit.* note 75.

[78] IRS 2021 Instructions for Schedule SE (2021), *2021 Instructions for Schedule SE (2021)*. Available at: irs.gov/instructions/i1040sse.

[79] Delaware General Assembly Section 17-301-306.

[80] *Op. cit.* note 47.

[81] *See* PLR 9432018, PLR 9452024, PLR 9525058, *Op. cit.* note 44, *Op. cit.* note 51, *Op. cit.* note 54.

[82] Section 6110(k)(3); Section 6110(b)(1)(A). (The Tax Court issues three main types of decisions, namely, T.C. Opinions, T.C. Memorandum Opinions, and T.C. Summary Opinions. Only the first type, called a "published" opinion, generally constitutes binding precedent for Tax Court purposes. *See* Section 7463(b); *Nico v. Commissioner,* 67 T.C. 647, 654 (1977) (stating that "we consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent"); *Huffman v. Commissioner*, 126 TC 322, 350 (confirming that "memorandum opinions are not binding"); Halpern, J.S., "What has the Tax Court been doing? An update," *Tax Notes* (May 30, 2016) (explaining that the "official position of the Tax Court appears to be that, with respect to memorandum opinions, we are not bound by the doctrine of stare decisis").)

of the medical facility, but they separately paid the taxpayer for his surgical services. Therefore, the Tax Court held that the taxpayer was a limited partner not subject to SECA taxes with respect to MBJ.

Castigliola v. Commissioner. The taxpayers in *Castigliola v. Commissioner* were a group of attorneys who practiced law through a firm organized as a professional limited liability company ("PLLC") in Mississippi.[60] The PLLC was treated as a partnership for federal tax purposes, filing an annual Form 1065. During the relevant years, the firm had a Compensation Agreement, which called for certain guaranteed payments to the members. Any amounts remaining thereafter were distributed to the members.

Based on the advice of their longstanding accountant, the taxpayers reported the guaranteed payments as self-employment income and paid SECA taxes, but they did not pay SECA taxes on their distributive shares in excess of the guaranteed payments. The IRS audited the taxpayers and claimed that *all* amounts received from the PLLC should have been subject to SECA taxes. The dispute eventually found its way to Tax Court.

The Tax Court began by summarizing *Renkemeyer*. Based on that case, the Tax Court held that its first job was to determine whether the party claiming the benefit of the limited partner exception under Section 1402(a)(13) held a position that is functionally equivalent to that of a limited partner in a limited partnership. In other words, "the issue is whether a member of such a [member-managed] PLLC is functionally equivalent to a limited partner in a limited partnership."[61]

The Tax Court examined several sources describing the characteristics of a limited partnership. It observed that the most common were limited liability and lack of control over the business. In this case, the PLLC was member-managed, such that each attorney had power over the business. The Tax Court pointed out that the PLLC lacked a written operating agreement or any other evidence of limitations on control. Moreover, all members actually participated in control by supervising associate attorneys and making decisions about distributive shares, borrowing money, personnel, etc. The Tax Court also underscored that the PLLC did not have at least one general partner, which is a requirement for a limited partnership. The members confirmed this, testifying that they each participated equally in decisions and had substantially identical relationships with the PLLC. For these reasons, the Tax Court determined that the taxpayers were not limited partners for purposes of Section 1402(a)(13).

Joseph v. Commissioner. The taxpayer in *Joseph v. Commissioner* was a doctor, who had ownership interests in many entities, and who had trouble filing his Forms 1040 on time.[62] At some point, the IRS audited the taxpayer and then issued a Notice of Deficiency, alleging, among other things, that he owed SECA taxes with respect to certain entities. Tax Court litigation ensued.

The parties focused their attention on Greenville Avenue Surgical Partners, LP ("GASP"), a limited partnership. The taxpayer raised several defenses over the course of the litigation, first arguing that income from a partnership is never subject to SECA taxes, then suggesting that he was not taxable because he held a limited partner interest, and, finally, clarifying that he should benefit from the limited partner exception under Section 1402(a)(13).

The Tax Court disagreed. It recited its earlier holding in *Renkemeyer*, suggesting that just having limited liability will not suffice, and a taxpayer can only benefit from the exception if he "is merely a passive investor in the entity who does not actively participate in the entity's business operations."[63] In this case, the taxpayer testified that he used GASP to receive income for various surgeries he performed for another entity. Thus, the Tax Court concluded that the taxpayer "actively participated" in the business and was not a limited partner under Section 1402(a)(13).

The recent lead-up to Sirius

IRS initiates a compliance campaign in 2018. The IRS believed that certain taxpayers were inappropriately taking advantage of Section 1402(a)(13). According to the IRS, some entities treated as partnerships were classifying *all* members as limited partners, thereby avoiding SECA taxes on partnership distributions altogether. Other partnerships were taking a more moderate approach, arguing that only a portion of the distributions should be subject to SECA taxes. They accomplish this by labeling some small amounts as wages or guaranteed payments to partners, while classifying the majority as a distributive share to limited partners and thus exempt from SECA taxes.

The IRS, therefore, initiated a compliance campaign in 2018 to stop these practices. The IRS summarized the problem as follows: "Some individual partners, including service partners in service partnerships organized as state law limited liability partnerships, limited partnerships, and limited liability companies, have inappropriately claimed to qualify as 'limited partners' not subject to SECA tax."[64]

IRS issues a concept unit in 2019. The IRS introduced a concept unit to its personnel to assist them in implementing the compliance campaign. The concept unit contained a few noteworthy items. First, it acknowledged that Section 1402(a)(13) does not define the term limited partner, and final regulations are non-existent, such that IRS personnel must rely solely on legislative history and case law in making determinations.[65] Second, the concept unit states that it is not restricted to just limited partnerships and LLCs; it applies to *all* entities treated as partnerships for federal tax purposes, including joint ventures, LLPs, LLLPs, and other entities.[66] Third, the concept unit instructs IRS personnel to ignore a long list of the Tax Court cases holding in favor of taxpayers and focused on limited partners and the passive activity loss-limitation rules under Section 469. The concept unit states that "the material participation rules under [Section] 469 have no bearing on whether an individual partner may be subject to self-employment taxes under [Section] 1402."[67]

IRS removes issue from its list of priorities in 2019. In what cannot be a coincidence, the IRS discretely removed the limited partner and SECA tax issue from its list of priorities, just around the time that it announced its compliance campaign. For many years, the annual "Priority Guidance Plan" published by the IRS contained the following entry: "Guidance on the application of [Section] 1402(a)(13) to limited liability companies."[68] This disappeared after 2018, without the IRS ever issuing the promised guidance.[69]

Biden administration urges congressional action in 2021. The Biden Administration recently issued its revenue proposals for 2022 ("Green Book").[70] One goal is to "rationalize" conflicting rules relating to SECA taxes. The Green Book explains that, because Section 1402(a)(13) only refers to limited partners, questions have arisen regarding whether it encompasses members of LLCs and owners of other pass-through entities.[71] The Green Book contains various proposals aimed at solving the perceived problem. One such proposal is having Congress pass legislation that would cause limited partners and members in LLCs who "materially participate" in a business to pay SECA taxes on their distributive shares until reaching a certain threshold.[72]

IRS representatives threaten more litigation in 2021. Attorneys from the IRS's National Office announced in 2021 that the IRS intends to continue auditing and litigating SECA tax cases involving limited partners.[73]

Pending Tax Court case

The stage is set for perhaps the most significant judicial decision regarding SECA taxes and partnerships in over a decade. Many eyes are focused on a pending Tax Court case, *Sirius Solutions, LLLP v. Commissioner.*[74]

Just the facts, ma'am. Sirius Solutions ("Sirius") is an LLLP formed in Delaware in 2002 and governed by a Limited Partnership Agreement. Sirius is a consulting firm consisting of over 200 employees located in various offices. It is managed by Sirius Solutions GP, LLC ("General Partner"), which must act through a board of directors.

The Limited Partnership Agreement generally prohibits limited partners from participating in management or control of the business. The Limited Partnership Agreement also broadly forbids limited partners from transacting business for, acting on behalf of, or binding Sirius. Finally, the Limited Partnership Agreement does not permit any "guaranteed payments" to partners, and Sirius made no such payments.

At the start of 2014, the only year in dispute with the IRS, nine individual limited partners and the General Partner owned Sirius. Two individual partners retired and liquidated their ownership interests during the year, and two others voluntarily withdrew as partners and became full-time employees. Thus, at the end of 2014, five individual partners and the General Partner remained.

All limited partners made capital contributions to Sirius, some of which were significant. In addition to providing cash, some partners contributed services to Sirius.

Sirius made distributions of "net cash flow" to the limited partners in 2014 in accordance with their ownership interests. Such distributions were subject to business risk. The distributions were not linked to, or dependent on, hours worked, revenues generated, or any other formula related to services provided by the limited partners. Indeed, the limited partners who provided few or no services received the same pro-rata distributions.

Sirius took the position on its Form 1065 for 2014 that the distributions to the limited partners were not subject to SECA thanks to the exception in Section 1402(a)(13). The IRS later audited Sirius and issued a Notice of Final Partnership Administrative Adjustment ("FPAA"), which contained the following allegation:

> It is determined that your ordinary income from business consulting services is included in net earnings from self-employment for which your individual partners are liable for the self-employment tax imposed by [Section] 1401. It is further determined that your individual partners are not 'limited partners' within the meaning of [Section] 1402(a)(13), and thus their distributive shares of the partnership's ordinary business income are not excluded from their net earnings from self-employment. Therefore, the net earnings from self-employment is $5,915,918 rather than $0, as shown on your [Form 1065]. Accordingly, the net earnings from self-employment is increased by $5,915,918.

Summary judgement motion and opposition. Sirius disagreed with the IRS's position in the FPAA, of course, and challenged it by tendering a Petition to the Tax Court. The parties completed their initial pleadings, the trial was postponed, and Sirius submitted a Motion for Summary Judgment during the reprieve. Sirius asked the Tax Court to determine, without the need for a trial, that distributions to individuals who are limited partners according to relevant state law (in this case, Delaware) are excluded from SECA taxes under Section 1402(a)(13) as a matter of law. The IRS strongly opposed the Motion for Summary Judgment. As of July 2022, the matter rests with the Tax Court.

Arguments of the parties.

The legal briefing by the parties in *Sirius Solutions, LLLP v. Commissioner* was extensive and detailed; capturing it all in this article would not be feasible. The following, therefore, is merely a summary of the main points.

Main positions: Sirius. The main positions held by Sirius are as follows:

- Sirius explained that Section 1402(a)(13) generally states that "the distributive share of any item of income or loss of a limited partner" is excused from SECA taxes.[75]
- The Internal Revenue Code does not define the term "limited partner," and the IRS has never issued any final regulations containing such definition. Therefore, the Tax Court should look to the "ordinary meaning" of the term at the time that Section 1402(a)(13) was enacted, in 1977.
- The ordinary meaning of limited partner is a person who satisfies the definition of limited partner under the relevant state law. A limited partner under the laws of Delaware, the state in which Sirius was formed, is a person admitted to a limited partnership as a limited partner.
- In 1997, Congress "confirmed" that term limited partner for purposes of Section 1402(a)(13) means a limited partner under applicable state law. It did so by imposing a moratorium against the IRS finalizing the Second Proposed Regulations, as they constituted an impermissible change of law by the executive branch, the IRS, instead of by the legislative branch, Congress. The moratorium is "important evidence" that Congress "made a considered judgment to retain the relevant statutory text."[76]
- Congress has amended Section 1402 a total of 32 times since adding Section 1402(a)(13) in 1977, and 14 of these times occurred after Congress imposed the moratorium in 1997. Despite all those opportunities, Congress never defined or altered the term limited partner.
- When it comes to statutory interpretation, it is unnecessary to consider outside sources, including legislative history, when a statute is clear on its face. Section 1402(a)(13) is clear on its face in that the exception to SECA taxes applies to limited partners, unless they received guaranteed payments in exchange for services rendered to the partnership. In light of the clarity of Section 1402(a)(13), the analysis should begin and end with that provision.
- Even if it were necessary to turn to outside sources, like legislative history, it "corroborates" that the limited partners in Sirius satisfy the definition. Moreover, the legislative history recognizes the appropriateness of bifurcating distributions (with some being subject to SECA taxes and some not) when a partner is acting as both a general partner and limited partner. Thus, any participation by the limited partners of Sirius in the board of directors would not trigger blanket exposure to SECA taxes.
- The IRS has issued various administrative rulings and Instructions to tax and information

returns indicating that the term limited partner for purposes of Section 1042(a)(13) means a person defined as such under applicable state law. For instance, the Instructions to Form 1065 for 2014 informed taxpayers that a limited partner was "a partner in a partnership formed under a state law limited partnership law, whose personal liability for debts is limited to the amount of money or other property contributed or is required to contribute to the partnership."[77] Additionally, the Instructions for Schedule SE (Self-Employment Tax) for 2014 explained that, in calculating self-employment taxes, limited partners "should include only guaranteed payments for services actually rendered to or on behalf of the partnership."[78] Sirius warned the Tax Court that accepting the IRS's position would effectively mean telling all taxpayers that they cannot rely on express guidance from the IRS in completing returns, which would make compliance virtually impossible for ordinary taxpayers.

- The "functional test," which the Tax Court used in *Renkemeyer,* only applies to modern entities that are not limited partnerships under state law. It is improper to utilize the "functional test" in other scenarios. Sirius is a Delaware limited partnership, whereas *Renkemeyer involved a special entity treated as a Kansas general partnership.*
- Decisions in various federal cases support the notion that the term limited partner for purposes of Section 1402(a)(13) means a limited partner as defined by state law.
- Courts frequently look to state law, such as Delaware partnership law, in applying federal tax law.
- Treating the limited partners in Sirius as such would not start a trend of imposing disparate federal tax treatment on similarly-situated taxpayers.
- Delaware law contains a non-exclusive list of activities (*i.e., safe harbors),* the performance of which by limited partners does not constitute participation in the management or control of the partnership and does not cause them to lose their status as limited partners. In particular, Delaware law states that a limited partner does not "participate in the control of the business" as a result of the following: (i) Transacting business with a limited partnership or its general partner; (ii) Being a member, manager, agent, or employee of an LLC that serves as a general partner of a limited partnership; (iii) Consulting with or advising a general partner or any other person with respect to any matter, including the business of the limited partnership; (iv) Guarantying or assuming any obligations of the limited partnership or general partner; or (v) Convoking, requesting, attending, or participating in a meeting of the partners or limited partners.[79] Therefore, none of the allegations by the IRS about supposed activities of the limited partners in Sirius rises to the level of "control" under Delaware law.
- There are no genuine disputes of fact regarding material issues in this case; therefore, the Tax Court should be able to resolve matters by ruling on the Summary Judgment Motion. Indeed, the only fact necessary for the Tax Court to rule in favor of Sirius is that the limited partners meet the definition of limited partner under Delaware law. The IRS is trying to fabricate a factual dispute to prevent a swift Tax Court ruling on this fundamental issue.

Main positions: IRS. The main positions held by the IRS are as follows:

- The IRC does not define limited partner for purposes of Section 1402(a)(13). The term is nuanced, complex, and based on the functions performed by particular individuals; state law does not determine it.
- The IRS agrees with Sirius in that the term "limited partner" should be given its "ordinary meaning," but it disagrees on how it should be determined. The IRS urges the Tax Court to ignore the large number of dictionary definitions introduced by Sirius and, instead, focus solely on its earlier decision in *Renkemeyer.* The IRS insists that such case looked to the legislative history from 1977, concluded that limited partners are equivalent to passive investors, and held that it is necessary to utilize a "functional test" that evaluates the actions and abilities of the partners, not merely their state law titles. In other words, the IRS seems to lobby for use of a facts-and-circumstances test and the substance-over-form doctrine.
- The Tax Court has "continued to follow and build upon" the holding in *Renkemeyer in subsequent cases.*[80]
- Reports by the Joint Committee on Taxation, Private Letter Rulings, and Instructions to tax and information returns do not constitute federal tax authorities, and the Tax Court should ignore them.
- The regulatory moratorium in 1997 does not mean that Congress "confirmed" or "made clear" the proper definition of limited partner. Rather, the moratorium merely shows that

Congress was concerned that the Second Proposed Regulations might contains rules that exceed the IRS's regulatory authority.

- The only legislative history that might be relevant to this case is that from the time Section 1402(a)(13) was enacted in 1977, not from 20 years later when the moratorium occurred in 1997.
- Contrary to what Sirius suggests, federal courts do not commonly look to state law in applying federal tax law. In fact, federal law supersedes state law thanks to the Supremacy Clause of the U.S. Constitution. State law controls only when the relevant federal law, by express language or necessary implication, makes interpretation of federal law dependent on state law. Section 1402(a)(13) never mentioned state law, and entity-classification at the federal level is done in accordance with specific tax regulations.
- If the Tax Court were to accept the contention by Sirius that state law (in this case, Delaware partnership law) dictates the outcome for purposes of Section 1402(a)(13), this would spark a bad overall result. Specifically, the IRS urges the Tax Court to ponder 50 different states, with 50 different partnership laws, rendering 50 different results.
- The Revenue Proposals for 2022 of the Biden Administration, as found in the Green Book, do not constitute precedent and do not warrant inclusion in the analysis. Even if the Tax Court were to consider the Green Book, Sirius allegedly misinterprets what it signifies. The IRS claims that the presidential suggestions are designed to ensure consistent tax treatment for all business income from pass-through entities, not solely to address the definition of limited partner for purposes of Section 1402(a)(13).
- Material facts remain in dispute, such that resolution of this case, without a trial, through a Summary Judgment Motion, is improper. Moreover, because the "functional test" described in *Renkemeyer* mandates a review of all relevant facts and circumstances, including the actions and abilities of the partners, a trial is necessary to develop more evidence.

Conclusion

How did it come to this? Well, Congress introduced SECA taxes in 1950, and they originally covered distributive shares to *all partners,* both general and limited. A little more than a quarter century later, in 1977, Congress created the exclusion in Section 1402(a)(13) to halt people from improperly labeling themselves limited partners with the goal of paying small amounts of SECA taxes in the present to get large amounts of Social Security benefits in the future. In light of the exclusion's purpose, Congress logically aimed to broadly apply the term limited partner in order to prevent as many people as possible from inappropriately accessing Social Security. Congress did not, however, define the term limited partner in the legislation.

Circumstances changed over the years, with states introducing new types of entities and the SECA tax rate increasing significantly. These new realities made it desirable for the IRS to change course and *narrowly interpret* the concept of limited partner. Therefore, in 1994, the IRS issued the First Proposed Regulations, which it later withdrew. The IRS then issued the Second Proposed Regulations in 1997. Congress imposed a moratorium on the IRS that same year, provisionally stopping it from finalizing the Second Proposed Regulations. The moratorium was temporary, however, only prohibiting regulatory actions until July 1, 1998. In other words, the IRS could have finalized the Second Proposed Regulations (with their "functional test" and special rules for "service partners" in "service partnerships") at any time after July 1, 1998. More than two decades have passed since then, but the IRS has not finalized the Second Proposed Regulations or presented alternative regulations regarding Section 1402(a)(13) and limited partners.

The IRS issued a number of rulings, and the courts published several decisions, over the following years focused on limited partners and SECA taxes. The rulings and cases can be divided into three main categories. The first category involved situations where individual taxpayers had an *informal partnership:* a joint venture or pooling of funds to invest. The second category featured situations where individuals who were partners in a limited partnership bifurcated the amounts that they received from the partnership. They subjected certain amounts to employment taxes, classifying them as distributions to general partners, guaranteed payments, or wages. They shielded other amounts from SECA taxes pursuant to the limited partner exception. The third category explored how the limited partner exception applied to entities that were not formed as limited partnerships under state law, such as LLCs.[81]

Arguably, none of the preceding categories is similar to *Sirius Solutions, LLP v. Commis-*

sioner because Sirius is not an informal general partnership, Sirius did not bifurcate payments, and Sirius was an LLLP under Delaware law, not another type of entity. Moreover, all the rulings and cases comprising the three categories are of questionable value to the IRS. This is because most came in the form of Chief Counsel Advisories and "Memorandum Opinions," which do not constitute precedent.[82]

The Tax Court decided the *only* case with precedential value in 2011, Renkemeyer. However, it dealt with a Kansas entity treated as a general partnership, whereas *Sirius Solutions, LLLP v. Commissioner* involves a Delaware limited partnership.

Another half-decade or so passed, and a series of events occurred. The IRS unveiled a compliance campaign in 2018 on grounds that some taxpayers were inappropriately relying on the limited partner exclusion. The IRS then issued a concept unit to its audit personnel in 2019. At the same time that the IRS was assailing taxpayers in earnest, it was also depriving them of hope for answers. Specifically, in 2019, the IRS removed from its list of priority projects the issuance of guidance about limited partners and the exclusion under Section 1402(a)(13). As if that were not enough, the IRS announced in 2021 that it planned to conduct more audits and Tax Court litigation centered on limited partners.

Now, after *not* issuing final regulations for nearly 45 years (which could have clarified limited partner matters, provided certainty, and minimized disputes), the IRS continues its attacks in *Sirius Solutions, LLLP v. Commissioner.* In doing so, the IRS is asking the Tax Court to apply a "functional test" and special standards for "service partnerships," two concepts it introduced in the Second Proposed Regulations way back in 1997, which never took legal effect. It is also requesting that the Tax Court give credence to certain administrative rulings and court decisions that lack precedential authority. In the same breath, the IRS is urging the Tax Court to ignore reports by the Joint Committee on Taxation, Private Letter Rulings, IRS Instructions to relevant returns, the Green Book, and state law directly on point.

Partnerships, partners, and tax professionals eagerly await the Tax Court's decision.