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CHAOS: SECA TAXES, LIMITED PARTNER EXCEPTION, AND GOVERNMENTAL INACTION

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This article, the first in a series examining self-employment taxes, the limited partner exception, and the IRS's current compliance campaign, chronicles the major events in the application of SECA taxes to modern entities classified as partnerships.

Introduction

Many entities treated as partnerships for federal tax purposes are now under attack by the U.S. Internal Revenue Service ("IRS"). What have they done wrong? Well, according to the IRS, they have incorrectly treated their owners as "limited partners," thereby allowing them to escape self-employment taxes, also known as Self Employment Contributions Act ("SECA") taxes, on their distributive shares. Tax enforcement is fine, but criticisms arise when one realizes that the positions taken by partnerships are based on a law enacted in 1977, which has never been updated or clarified by Congress or the IRS. The broad scope of the "limited partner" exception from the outset, coupled with governmental inaction during the next five decades, has led to chaos. This article, the first in a series, chronicles the major events culminating in the current confusion about the application of SECA taxes to modern entities classified as partnerships.[1]

Overview of SECA Taxes

Amounts earned by taxpayers for working generally are subject to so-called "employment taxes." When dealing with "employees," they are comprised of several items, including Federal Insurance Contributions Act ("FICA") taxes, which fund Social Security and Medicare. However, in situations involving sole proprietors, independent contractors, and partners, SECA taxes substitute FICA taxes.[2] For 2020, the SECA tax rate was 15.3% of "net earnings from self-employment," which can represent a big payment for a taxpayer who is prospering.[3]

The term "net earnings from self-employment" normally 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 from any partnership in which he is a partner.[4] A number of exceptions exist. Importantly, Section 1402(a)(13) excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share to a "limited partner," as a limited partner, other than certain guaranteed payments.[5]

The Long Road to Uncertainty

The Compliance Campaign that the IRS is currently conducting, along with other events described later in this article, mean that many enti-

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ties treated as partnerships are already under siege, or soon will be. Partnerships and their partners will be unable to adequately defend their positions unless they understand where we are now and how things became this warped.

Several articles have been written about SECA taxes and partnerships over the years.[6] This article is unique, though, in that it describes, largely in chronological order, the major events through 2021 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 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 subject to SECA taxes initially.[8]

Limited Partner Exception Appears in 1977. Things changed when Congress developed a carve-out for limited partners.

Statutory Language. In 1977, Congress enacted 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.

Legislative Rationale. Understanding why Congress created Section 1402(a)(13) is pivotal. The IRS and several courts have focused primarily, if not solely, on the following portion of the legislative history:

> Under present law, *each partner's share of partnership income* is includable in his net earnings from self-employment for Social Security purposes, *irrespective of the nature of his membership in the partnership.* The bill [introducing Section 1402(a)(13)] 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 . . . .*[10]

In making determinations, the IRS and courts have often ignored other portions of the same legislative history that raise the possibility of allocating income between SECA amounts and non-SECA amounts. The following excerpt from the key congressional report arguably approves bifurcation of income:

> 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].[11]

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

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1 The other two articles in the series are as follows. Sheppard, "The Resurgence of IRS Disputes about Which 'Limited Partners' Escape SECA Taxes Thanks to the Section 1402(a)(13) Exception," 49 Corp. Tax'n No. 1 (forthcoming, 2022); Sheppard, "Heads the IRS Wins, Tails the Taxpayers Lose: Analyzing Inconsistent Positions on the Meaning of 'Limited Partners,'" 49 Corp. Tax'n No. 2 (forthcoming, 2022).

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

3 Section 1401(a) and (b).

4 Section 1402(a).

5 Section 1402(a)(13).

6 See, e.g., Dilley, "Breaking the Glass Slipper – Reflections on the Self-Employment Tax," 54 Tax Law 65 (2000); Banoff, "Renkemeyer Compounds the Confusion in Characterizing Limited and General Partners – Part I," 115 J. Tax'n 306 (2011); Fritz, "Flowthough Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?" 17 Virginia Tax Review 811 (1998); Marquis, "Current Status of Limited Liability Companies and the Self-Employment Income Tax," 77 Michigan Bar Journal 440 (May 1998); Koski, "Self-Employment Tax and Limited Liability Companies: When Are LLC Earnings Subject to Self-Employment Taxes?" 83(9) Taxes – The Tax Magazine 33 (Sept. 2005); Koski, "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," 89(8) Taxes – The Tax Magazine 37 (Aug. 2011); Koski, "Surgeon Escapes Self-Employment Tax on Distributive Share of LLC Income from Surgery Center – Application of SE Tax to LLCs Remains Unclear," 95(8) Taxes – The Tax Magazine 31 (Aug. 2017); Trivedi, "Renkemeyer Facts Limit Decision's Scope, Practitioners Say," 133 Tax Notes 555 (Oct. 31, 2011); S. Megaard & M. Megaard, "Reducing Self-Employment Taxes on Owners of LLPs and LLCs After Renkemeyer," 87 Practical Tax Strategies 52, August 2011; Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," 130 Tax Notes 1244 (Mar. 14, 2011); Karlinsky, "Self-Employment Taxes and PALs: The Case of LLCs," 132 Tax Notes 1391 (Sept. 26, 2011); Winchester, "The Gap in the Employment Tax Gap," 20(1) Stanford Law & Policy Review 127 (2009); Culpepper et al., "Self-Employment Taxes and Passthrough Entities: Where Are We Now?" Tax Notes 211 (Oct. 10, 2005); Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70(4) Washington and Lee Law Review 2389 (2013).

7 Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax (Sept. 2012), page 1.

8 TD 7333 (Dec. 19, 1974); Reg. 1.1402(a)-2(d).

9 Social Security Amendments of 1977, P.L. 95-216, section 313(b).

10 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), page 11 (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), page 40.

> 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 borne 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.[12]

A careful reading reveals that Congress was concerned that (i) unscrupulous persons were selling limited partner interests solely for purposes of allowing individuals who were otherwise ineligible for the Social Security program to gain access; (ii) based on the minimum contribution they made to the partnerships and the minimum distributive shares they received, 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 any significant SECA taxes given the minimum distributive shares they received; (iv) the purchasers of the limited partner interests would obtain 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 public resentment and claims of unfairness.

Broad Solution to Fix Narrow Problem. Congress was focused on a particular problem; that is, some individuals were taking actions to improperly make themselves subject to SECA taxes. Readers might ask why anyone in his right mind would voluntarily pay SECA taxes. Well, it made sense back in those days, because the SECA tax rate was low, the individuals only planned to expose a very small amount of income (around $400 annually) to SECA taxes, and the value of the Social Security benefits, particularly on a weighted scale, was higher than the cost of the SECA taxes.[13]

In 1977, Congress enacted Section 1402(a)(13), which was an exception from SECA taxes for certain "limited partners."

To address the *very narrow problem* related to the exploitation of the Social Security program, Congress implemented a *very broad solution* in 1977. Namely, it introduced Section 1402(a)(13), which generally excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share to a "limited partner." Congress effectively turned the tables because of its actions. From that point forward, as the SECA tax rate increased, the types of business entities available proliferated, and the longevity and financial stability of the Social Security system came into question, many taxpayers arranged their affairs to fit within the "limited partner" exception in Section 1402(a)(13) and avoid the obligation of paying SECA taxes.

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").[14] They contained rules for treatment of limited partners in partnerships, as well as members of limited liability companies ("LLCs") treated as partnerships.[15]

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.[16] They

[12] 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), pages 40-41.

[13] Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70(4) Washington and Lee Law Review 2389 (2013) (explaining that the SECA tax rate was merely 7.9% and it applied only to the first $16,500 of net earnings).

[14] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).

[15] 59 Fed. Reg. 67253, EE-45-94, Prop. Reg. 1.1402(a)-18 (Dec. 29, 1994).

went on to explain that a member of an LLC would be treated as a "limited partner" for purposes of Section 1402(a)(13) if the member met two criteria. First, the member could not be a "manager" of the LLC.[17] Second, the pertinent entity could have been formed as a limited partnership instead of an LLC, and the member could have qualified as a limited partner instead of a member.[18]

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.[19] 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 a member of an LLC, and a limited partner in a limited partnership, who got involved in management or control of an entity to the same degree would be treated similarly for purposes of SECA taxes.[20]

In making determinations, the IRS and courts have often ignored other portions of the same legislative history that raise the possibility of allocating income between SECA amounts and non-SECA amounts.

Definitions mattered, of course. The First Proposed Regulations described an LLC as an entity that (i) was classified as a partnership for federal tax purposes, and (ii) allowed for limited liability of its members for the debts and other obligations of the entity under applicable state law.[21] 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 the management decisions for the LLC.[22] 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.[23]

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").[24] 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.[25]

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.[26] 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 for more than 500 hours during a year.[27]

Two Special Rules. The Second Proposed Regulations featured two special rules, which

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

[17] 59 Fed. Reg. 67253, EE-45-94, Prop. Reg. 1.1402(a)-18(b)(1) (Dec. 29, 1994).

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

[19] 59 Fed. Reg. 67253, EE-45-94, Prop. Reg. 1.1402(a)-18 (Dec. 29, 1994), Preamble – Explanation of Provisions.

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

[21] 59 Fed. Reg. 67253, EE-45-94, Prop. Reg. 1.1402(a)-18(c)(1) (Dec. 29, 1994).

[22] 59 Fed. Reg. 67253, EE-45-94, Prop. Reg. 1.1402(a)-18(c)(3) (Dec. 29, 1994).

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

[24] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.

[25] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); 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.")

[26] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(g).

[27] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(h)(2).

were designed to exclude from SECA taxes "amounts that are demonstrably returns on capital invested in the partnership."[28]

An individual holding more than one class of interest in a partnership, who was not already treated as a limited partner under the new definition, would be considered a limited partner if, immediately after he acquired the relevant interest, (i) limited partners under the new definition owned a substantial and continuing interest of the specific class, and (ii) the individual's rights and obligations with respect to the interest were identical to those of other limited partners.[29]

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

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.[31] For these purposes, the term "service partner" meant a partner who provided services either to a partnership or on behalf of a partnership's trade or business.[32] 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.[33]

Example. The Second Proposed Regulations offered one detailed example. It is set forth below, with several modifications by the author to make it more understandable.[34]

> ***Facts.*** A, B, and C form LLC, a limited liability company, under the laws of a state to engage in a business that is not a "service partnership." LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25% of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC, and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under applicable state law, C has the authority to contract on behalf of LLC.[35]
>
> ***Application of new definition of limited partner.*** A is treated as a limited partner because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under Section 1402(a)(13).[36]
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> ***Application of the special rule for individuals who hold one class of interest and significantly participate in the partnership.*** B's guaranteed payment of $6x is included in B's net earnings from self-employment. B is not treated as a limited partner because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under applicable state law, B participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under the special rule for certain individuals holding more than one class of interest because B does not hold more than one class in LLC. However, B is treated as a limited partner because B is not treated as a limited partner under the new definition solely because B participated in LLC's business for more than 500 hours, and because A is a limited partner under the new definition who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment.[37]
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> ***Application of the new definition and two special rules.*** C's guaranteed payment of $10X is included in C's net earnings from self-employment. In addition, C's distributive

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.

[28] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[29] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(h)(3).

[30] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. 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 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[31] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(h)(5).

[32] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(h)(6)(i).

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

[34] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(i).

[35] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(i)(i).

[36] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(i)(ii).

[37] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(i)(iii).

share attributable to C's LLC unit also is net earnings from self-employment because C is not a limited partner under the new definition or either of the two special rules. C is not treated as a limited partner under the new definition because C has the authority under applicable state law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under the special rule for individuals holding more than one class of interest because C does not hold more than one class. Finally, C is not treated as a limited partner under the special rule for individuals who hold only one class of interest but who participate in the partnership's trade or business more than 500 hours during the year because C has the power to bind LLC. Thus, C's guaranteed payment *and* his distributive share both are included in C's net earnings from self-employment.[38]

The IRS aimed to ensure that a member of an LLC, and a limited partner in a limited partnership, who got involved in management or control of an entity to the same degree would be treated similarly for purposes of SECA taxes.

IRS Rationales. The Preamble to the Second Proposed Regulations explained that the IRS wanted the same standards to apply to owners of an interest in a limited partnership and owners of any other entity treated as a partnership, such as an LLC. To achieve the desired "conformity," the IRS adopted a method that looked to the relationship between the individual, the partnership, and the partnership's business.[39]

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.[40] 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 needed to rely on a "functional approach" to ensure that the SECA tax consequences were similar for all individuals, regardless of the state in which the relevant partnership was organized.[41]

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.[42]

Congress Imposes a Moratorium in 1997. In a remarkable demonstration of governmental gridlock and political pandering, Congress stopped the IRS in its proverbial tracks. Specifically, Congress enacted a law in 1997 expressly stating 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."[43] This essentially created a moratorium on regulations for about 18 months. If that were not enough, Congress explained 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."[44]

In summary, Congress flexed its muscle to halt 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. Lamentably for the entire tax system, Congress has not issued any legislation to resolve the "limited partner" matter in two and one-half decades and the IRS, likewise, has not advanced any regulatory actions.

Various Groups Offer Proposals from 1998 to 2005. Several groups offered proposals in hopes of influencing Congress to take action during or soon after the moratorium.[45] Such action never occurred, of course, but it is interesting to review some of the most notable proposals.

Accountants' Comment in 1998. The American Institute of Certified Public Accountants ("AICPA") delivered a legislative proposal to congressional leaders in 1998.[46] Under the AICPA proposal, all partners generally would be required to pay SECA taxes on the value of services they perform for, or on behalf of, the partnerships. Such value would be based on a "general standard of reasonableness." Taxpayers and the IRS would first apply a safe harbor test to see if the value were reasonable. If the value varied from the safe harbor test by more than 10%, then a facts-and-circumstances test would come into play. The AICPA indicated

[38] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Prop. Reg. 1.1402(a)-2(i)(iv).

[39] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[40] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[41] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[42] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[43] Taxpayer Relief Act of 1997, P.L. 105-34, section 935 (Aug. 5, 1997).

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

[45] See, e.g., New York State Bar Association Tax Section, Legislative Proposal Regarding Employment Taxes and Professional Services Businesses (Sept. 21, 2010).

[46] "AICPA Forwards Legislative Proposal on Self-Employment Taxes," 99 Tax Notes Today 39-34 (Feb. 19, 1998); "AICPA Calls on Taxwriters to Amend Tax on Self-Employment Net Earnings," Tax Analysts Doc. 2000-17689 (July 10, 2000).

that the safe harbor amount would equal the partner's distributive share from the partnership, plus guaranteed payments for services rendered, minus a reasonable rate of return on the partner's capital account at the beginning of the relevant year. The AICPA clarified that the rate of return would be reasonable if it were less than 150% of the Applicable Federal Rate at the end of the year.

The AICPA also suggested a "de minimis exception" for partners who perform less than 100 hours of services for or on behalf of the partnership during a year. This exception, suggested the AICPA, would provide "administrative simplicity."

In addition to recommending rules to avoid potential abuses, the AICPA suggested that Congress allow partners who would otherwise be exempt from SECA taxes under Section 1402(a)(13) to make an affirmative election to pay these amounts and get the corresponding Social Security benefits in the future.

Tax Attorneys' Comment in 1999. The Tax Section of the American Bar Association ("ABA") also supplied Congress with a legislative proposal.[47] The ABA described the longstanding ambiguity in the area of SECA taxes, urging "prompt Congressional action" for members of LLCs and partners of partnerships of all types. The ABA emphasized that the current lack of guidance "encourages non-compliance by taxpayers and precludes uniform enforcement by the IRS."

The ABA, giving praise to its colleagues in the AICPA, said that the two groups agreed on many things. In particular, they both believed that (i) the solution must focus on whether income is attributable to services versus capital; (ii) an amended law by Congress would be better than regulations by the IRS; and (iii) where an individual member of an entity classified as a partnership contributes both services and capital to the enterprise, only income attributable to the services should be hit with SECA taxes, regardless of whether the individual is a general and/or limited partner, and regardless of whether the individual is a manager of the LLC. While the two groups agreed at the macro level, the ABA and AICPA offered slightly different ways for resolving the problem.

The ABA recommended that Congress modify Section 1402(a)(13) in several ways. First, Congress should delete the word "limited," such that the provision generally would apply to all general partners, limited partners, and members of LLCs. Second, it should add language to ensure that income "attributable to capital" would be excluded from SECA taxes. Items "attributable to capital" would be (i) any amount exceeding reasonable compensation for services rendered by the partner, or (ii) a reasonable rate of return on unreturned capital of the partner, determined as of the beginning of the relevant year. For these purposes, a "reasonable rate of return" would mean 150% of the highest Applicable Federal Rate at the beginning of the relevant year. Third, Congress should expressly authorize and instruct the IRS to issue regulations necessary to carry out the new rules.

Tax Writers' Comment in 2005. The U.S. Joint Committee on Taxation ("JCT"), at the request of Congress, issued a report presenting various options for improving tax compliance.[48] Among other things, the JCT suggested changing amounts subject to SECA taxes for general partners, limited partners, and members of LLCs. Underscoring the ambiguity regarding how to treat these individuals, the JCT admitted that "[t]his uncertainty makes compliance with the law difficult for taxpayers and administration of the law difficult for the IRS."[49]

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 for more than 500 hours during a year.

[47] "ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Rules," 1999 Tax Notes Today 133-23 (July 6, 1999); Stratton, "ABA/AICPA Have Legislative Fix for LLC Self-Employment Tax Problem," 1999 Tax Notes Today 139-3 (July 21, 1999); "Writer Asks Treasury to Support ABA/AICPA Proposal," 2001 Tax Notes Today 81-33 (Mar. 30, 2001).

[48] U.S. Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures JCS-0205 (Jan. 27, 2005).

[49] U.S. Joint Committee on Taxation, Summary of Joint Committee Staff – Options to Improve Tax Compliance and Reform Tax Expenditures, JCX-19-05R (Apr. 12, 2005), pages 9-10.

The main aspects of the JCT's proposal were as follows. First, *all* individuals treated as partners would be subject to SECA taxes on their distributive shares from partnerships. Second, in the case of so-called "service partnerships," SECA taxes would apply to *all* the income that partners receive. The term "service partnership" would encompass all entities treated as partnerships substantially of all whose activities involve performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Third, despite the preceding rules, if any partner (regardless of whether he is a general partner, limited partner, or member of an LLC) does not "materially participate" in the business of the partnership, then *only* such partner's "reasonable compensation" would be hit with SECA taxes.[50]

The Second Proposed Regulations featured two special rules, which were designed to exclude from SECA taxes "amounts that are demonstrably returns on capital invested in the partnership."

Summary of Proposals. The three proposals described above are nuanced. None is exactly the same, but they can be divided into three broad options for defining the SECA tax base.[51] The first is employing a "material participation" standard, which would apply rules similar to those currently utilized in passive activity loss-limitation cases under Section 469. With this option, individuals who materially participate in the business of the entity would be treated like *general* partners under existing law, while non-material participants would enjoy preferential treatment like *limited* partners. The distributive share of the latter would escape SECA taxes.[52]

The second main option is the "reasonable compensation" standard. Currently, corporations must report "reasonable compensation" earned by their shareholders, and employment taxes, called FICA taxes in that context, are imposed on such compensation. Some proposals suggest applying the same standard to entities classified as partnerships, thereby exposing to SECA taxes *only* the amount deemed to be reasonable compensation paid by the partnership for services rendered by the partner.[53]

The third option employs a "safe harbor" calculation of capital income to partners. Here, partnerships would apply a standard formula to determine the amount of income that would be considered a return on the capital investment by the partners, and thus free from SECA taxes. Partners would identify their capital base by adding the values of their capital assets, just as partnerships do when providing a balance sheet to the IRS. The partners would then multiply the total value of their capital base by 150% of the maximum Applicable Federal Rate for the relevant year. This, in theory, would show a reasonable rate of return on capital investment in partnerships by the partners. To put things in perspective, the rate of return in 2004 would have been 5.37% using the safe harbor formula.[54]

IRS Gives Taxpayers Hope in 2003. An IRS official gave taxpayers some degree of hope in 2003. She supposedly stated during a public event that "[if] the taxpayer conforms to the latest set of proposed rules [i.e., the Second Proposed Regulations], we generally will not challenge what they do or don't do with regard to self-employment taxes."[55]

IRS and Courts Publish Rulings – Focus on 2011. The IRS has issued various administrative rulings and the courts have published several decisions involving "limited partners" and SECA taxes over the years. However, as a result of the congressional moratorium, the analysis in these instances centered solely on the outdated text of Section 1402(a)(13) from 1977 and a portion of legislative history.

Three Main Categories. The authorities fit into three main categories. The first involves situations where individual taxpayers got involved in an informal partnership. The taxpayers considered it a simple investment, did not participate in the activity, fully reported the resulting

[50] U.S. Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-0205 (Jan. 27, 2005), pages 99-100.

[51] Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax, Publication 4168 (Sept. 2012), pages 18-23.

[52] Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax, Publication 4168 (Sept. 2012), page 19.

[53] Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax, Publication 4168 (Sept. 2012), pages 21-22.

[54] Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax, Publication 4168 (Sept. 2012), page 23.

[55] Bennett, "Taxpayers Can Rely on Proposed Regulations for LLC Self-Employment Taxes, Clark Says," 114 Daily Tax Report G-3 (June 13, 2003).

income on their Forms 1040 (U.S. Individual Income Tax Returns) and paid income taxes, but did not pay SECA taxes. The IRS argued that investing in working interests of mineral wells equates to carrying on a trade or business, either as a partner or through an agent, and the taxpayers were not "limited partners" under Section 1402(a)(13). The Tax Court explained that (i) the definition of "partnership" in the Internal Revenue Code is broad, encompassing syndicates, groups, pools, joint ventures, and other organizations through which any business, operation, or venture is carried out; (ii) various individuals combining funds to finance mineral exploration creates a pool or joint venture, which falls within the meaning of partnership; (iii) because the individuals were in a partnership, the amounts they received were distributive shares; (iv) all partners generally must pay SECA taxes on their distributive shares; and (v) the individuals do not qualify for the limited partner exception under Section 1402(a)(13) because they never filed the documents or took other necessary actions under applicable state law to establish a "limited partnership." Thus, the individuals were all general partners in a general partnership, subject to SECA taxes on their distributive shares.[56]

The second category features situations where individuals, who were partners in a limited partnership, bifurcated the amounts that they received from the partnership. They subjected certain amounts to self-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 in Section 1402(a)(13). The individuals in these types of cases often were actively engaged in the business of the partnerships, but they also made significant capital contributions to, or investments in, the partnerships. The IRS and the courts generally ruled in these situations that a longstanding Revenue Ruling establishes that partners are not employees of partnerships, existing rules do not permit inconsistent characterization of amounts from partnerships to limited partners based on wearing both a worker and investment hat, and the "reasonable compensation" principles applicable to corporations do not apply to partnerships.[57]

The third category addresses how the "limited partner" exception under Section 1402(a)(13) applies to entities that were not formed as limited partnerships under state law, such as LLCs. The analysis varied in each case, but the focus normally centered on the degree of the individual's participation in the business of the entity and whether, to borrow a phrase from the legislative history, the income he receives was "basically of an investment nature."[58]

Importantly, all the authorities described above are of questionable value to the IRS in future tax disputes with partnerships. This is because several came in the form of Chief Counsel Advisories. The Internal Revenue Code expressly states that "written determinations" of this sort ordinarily cannot be used or cited as precedent.[59] Other authorities consist of "Memorandum Opinions" by the Tax Court, which also fall short of the precedential bar.[60]

The Most Famous Case. The seminal case in this area is *Renkemeyer, Campbell & Weaver, LLP*.[61] Three individual partners and one corporate partner formed an LLP under Kansas law to operate their law practice ("Law Firm"). The Law Firm filed a timely Form 1065 (U.S. Return of Partnership Income) for 2004, showing revenues primarily generated by the performance of legal services. The Law Firm made distributions to the individual partners that year, did not report them as "net earnings from self-employment" by the Law Firm, and thus did not subject them 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

The Second Proposed Regulations indicated that an individual who is a "service partner" in a "service partnership" would *not* be a limited partner.

[56] See, e.g., *Johnson*, TCM 1990-461, *Perry*, TCM 1994-215, *Norwood*, TCM 2000-84 (Tax Court rejected the argument that an individual taxpayer can convert a general partner interest into a limited partner interest simply by not actively participating in the business).

[57] See, e.g., *Riether*, 112 AFTR2d 2013-6074, 919 F.Supp.2d 1140 (DC N.M., 2012), CCA 201436409, CCA 201640014, *Castigliola*, TCM 2017-62.

[58] See, e.g., Ltr. Rul. 9432018, Ltr. Rul. 9452024, Ltr. Rul. 9525058, *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011), *Howell*, TCM 2012-281, *Hardy*, TCM 2017-16.

[59] Section 6110(k)(3) and Section 6110(b)(1)(A).

[60] 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*, 67 TC 647, 654 (1977) (stating that "we consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent"); *Huffman*, 126 TC 322, 350 (2006) (confirming that "memorandum opinions are not binding"); Halpern, "What Has the Tax Court Been Doing? An Update," Tax Notes 1277 (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").

[61] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137 (2011).

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, which were devoid of SECA taxes again.

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).

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. In other words, the Law Firm endeavored to focus the issue solely on state law titles and exposure.

The Preamble to the Second Proposed Regulations explained that the IRS wanted the same standards to apply to owners of an interest in a limited partnership and owners of any other entity treated as a partnership, such as an LLC.

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."[62] The Tax Court indicated that an LLP 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 uses the phrase "limited partner," was enacted *before* LLPs and other modern entity forms came into existence. 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). It looked to just one portion of the legislative history, which stated the following:

> The bill would exclude from [SECA tax] 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 [SECA tax] coverage purposes certain earnings which are basically of an investment nature.*[63]

The Tax Court believed that this "insight" showed that Congress intended 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 SECA taxes.[64]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount of capital in exchange for their partnership interests, and the distributive shares that they received were not "earnings which are basically of an investment nature." Accordingly, the Tax Court concluded that the partners must pay SECA taxes on their distributive shares and the exception under Section 1402(a)(13) does not apply.[65]

IRS Authorities Give Taxpayers More Hope in 2011. An attorney in the IRS's National Office announced during a conference organized by the ABA in 2011 that, despite the holding in *Renkemeyer*, the Second Proposed Regulations had not been withdrawn and taxpayers "could rely" on them.[66] Others have explained that "IRS officials have said many times that the [IRS] will not challenge positions taken by taxpayers who rely on the proposed regulations to determine that a partner's earnings are not subject to self-employment tax."[67]

IRS Initiates Compliance Campaign in 2018. The IRS claims that certain taxpayers are inappropriately taking advantage of Section 1402(a)(13). According to the IRS, some entities treated as partnerships are classifying *all* members as "limited partners," thereby avoiding SECA taxes on partnership distributions altogether. Other partnerships are taking a more moderate approach, arguing that only a portion of the distributions should

[62] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 147 (2011).

[63] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011) (citing the Social Security Amendments of 1977, P.L. 95-216, section 313(b)) (emphasis added).

[64] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011).

[65] *Renkemeyer, Campbell & Weaver, LLP*, 136 TC 137, 150 (2011).

[66] Jackel, "Has Politics Trumped Policy?" 131 Tax Notes 745 (May 16, 2011); Trivedi, "After Renkemeyer, Passthroughs Can Still Rely Safely on Proposed Regs, Officials Say," 131 Tax Notes 675 (May 16, 2011).

[67] Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," Tax Analysts Doc. 2011-5140 (Mar. 11, 2011).

be subject to SECA taxes. They accomplish this by labeling some amounts as wages or guaranteed payments to partners, while the rest is classified as a distributive share to "limited partners."

The IRS, therefore, initiated a Compliance Campaign in 2018 to halt these practices, summarizing the problem as follows:

> Partners report income passed through from their partnerships. Unless an individual partner qualifies as a "limited partner" for [SECA] tax purposes, the partner's distributive share is subject to [SECA taxes]. 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.[68]

IRS Issues 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.[69]

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, LLCs, LLPs, LLLPs, limited partnerships, and other entities.[70]

Third, the Concept Unit instructs IRS personnel to ignore the long list of the taxpayer-favorable decisions regarding limited partners and the passive activity loss-limitation rules under Section 469, which are analyzed in a subsequent article of this series. 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."[71]

Fourth, the Concept Unit devotes three pages to a discussion of the Second Proposed Regulations, which were never finalized.[72] Interestingly, the IRS appears to have decided to overlook the incomplete status of the Second Proposed Regulations. The Concept Unit makes the following declaration in this regard:

> The 1997 Proposed Regulations are not final. They may not be enforced on taxpayers. Instead, the applicable analysis is the statutory language [in Section 1402(a)(13)], legislative history, and case law. *Taxpayers, however, may rely on the 1997 Proposed Regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 Proposed Regulations.*[73]

This announcement in the Concept Unit that the IRS will respect the taxpayer's choice of applying the Second Proposed Regulations is consistent with at least two earlier statements by high-ranking IRS officials back in 2003 and 2011.

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."[74] This disappeared after 2018, without the IRS ever issuing the promised guidance.[75]

Congress enacted a law in 1997 expressly stating 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."

Biden Administration Urges Congressional Action in 2021. The Biden Administration recently issued its revenue proposals for 2022 ("Green Book").[76] One goal is to "rationalize" conflicting rules relating to SECA taxes. The Green Book ex-

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[68] *www.irs.gov/businesses/corporations/lbi-active-campaigns.*

[69] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 10.

[70] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 3.

[71] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, page 13.

[72] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb. 13, 2019, pages 19-21.

[73] IRS, LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, Feb.13, 2019, page 19 (emphasis added).

[74] See, e.g., U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service, 2015-2016 Priority Guidance Plan (July 31, 2015), page 11.

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

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

[77] U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), page 65.

plains 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.[77] The Green Book contains various proposals aimed at solving the perceived problem. One such proposal is passing 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.[78]

Lamentably for the entire tax system, Congress has not issued any legislation to resolve the "limited partner" matter in two and one-half decades and the IRS, likewise, has not advanced any regulatory actions.

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 "limited partner" and SECA tax cases because it has been "fairly successful" in this area.[79]

Conclusion

Many readers might be asking themselves at this point, can things really be this jumbled? The short answer is, yes, they can be and they are. A summary of the long journey to chaos helps put things into perspective. Bullet points are a must to keep this all straight:

- Congress introduced SECA taxes in 1950, and they originally affected distributive shares to *all* partners.
- Congress discovered after several years that certain persons were selling limited partner interests solely for purposes of allowing individuals, who would otherwise *not* be eligible for the Social Security program, to obtain access. In other words, given the financial circumstances in that long ago era, individuals were taking steps to make themselves subject to SECA taxes.
- To halt this *narrow* problem, Congress introduced a *broad* solution; that is, it enacted Section 1402(a)(13) in 1977. This provision generally excluded from SECA taxes distributive shares to "limited partners." Thus, it became advantageous for taxpayers to fall into this category, at least from a tax perspective. Notably, Congress did not define, curtail, or caveat the term "limited partner" in the legislation.
- More time passed, state laws regulating the actions of limited partners became more flexible, and new types of business entities, such as LLCs, appeared. The IRS thought it was time for some guidance.
- Therefore, it issued the First Proposed Regulations in 1994, followed by the Second Proposed Regulations in 1997. Congress, facing outside pressure, imposed a moratorium on the IRS in 1997. As a result, the IRS never finalized the Second Proposed Regulations, never re-issued them, and never presented any alternative regulations.
- Various groups offered legislative proposals to Congress starting in 1998, hoping to help shape legislation during the moratorium or soon after it had expired. Specifically, the AICPA, ABA, and JCT suggested a "material participation" standard, a "reasonable compensation" requirement, a "safe harbor" for calculating investment income to partners, or some combination thereof. Congress did not act.
- IRS officials publicly stated in 2003 that the IRS did not intend to challenge partnerships regarding SECA taxes as long as they followed the Second Proposed Regulations.
- The IRS issued some rulings, and the courts published several decisions, focused on "limited partners" and SECA taxes during the ensuing years. Technically speaking, none of those authorities should be of help to the IRS in future disputes against partnerships because, as Chief Counsel Advisories and Tax Court Memorandum Opinions, they lack precedential value.
- The most famous case was *Renkemeyer*, decided in 2011. That Tax Court case arguably lacked broad value, though, because it only dealt with "service partners," working for a "service partnership," who made small capital contributions, and who were fully engaged in the management of the business.

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

[79] Taylor, "Clarity regarding 'Limited Partner' under SECA Remains Elusive," 2021 Tax Notes Today Federal 112-2 (June 11, 2021).

- As it did earlier in 2003, the IRS announced at a conference in 2011 that partnerships "could rely" on the Second Proposed Regulations. Some understood this to mean that, from the IRS's point of view, an individual was presumptively a limited partner, unless he was personally liable for the obligations of the partnership, or he had authority to enter into contracts for the partnership, or he participated for more than 500 hours annually in the partnership's business.
- Another half-decade passed, and the IRS changed course again. It claimed that certain taxpayers were inappropriately employing the "limited partner" exception under Section 1402(a)(13), the solution to which was to unveil a Compliance Campaign in 2018.
- In a move that might be considered erratic, the IRS then issued a Concept Unit to its personnel in 2019. It stated, among other things, that taxpayers "may rely" on the Second Proposed Regulations, and the IRS "will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the [Second] Proposed Regulations."
- That same year, 2019, the IRS removed from its list of priority projects the issuance of new administrative guidance regarding "limited partners" and Section 1402(a)(13).
- Approximately two years later, in 2021, the Biden Administration released its so-called Green Book containing various legislative suggestions. Among them was rationalizing the conflicting rules regarding SECA taxes by adding a "material participation" standard, as the IRS had attempted to do back in 1997 with the Second Proposed Regulations, and as the JCT had proposed in 2005.
- Finally, in 2021, attorneys from the IRS's National Office warned of more audits and litigation by the IRS on the "limited partner" issue, fueled by the fact that it has been "fairly successful" in exploiting taxpayers amid the turmoil caused, ironically, by the inaction of the IRS and Congress for decades.

This article is not a treatise on statutory interpretation. It suffices to explain that, just as courts ordinarily construe a contract in favor of the party that did *not* draft it, numerous tax cases have held that, in situations involving governmental ineffectiveness or inaction, tax provisions, like Section 1402(a)(13), should be resolved in favor of taxpayers.[80] After contemplating the events from 1950 to the present, it is unclear whether the courts will take this approach in future cases involving "limited partners" and SECA taxes, thereby forcing Congress and the IRS to carry out their respective functions. What is certain, though, is that the IRS will continue attacking distributive shares flowing from joint ventures, limited partnerships, LLCs, LLPs, LLLPs, and other entities treated as partnerships. Such entities must remain fully informed about the evolving issues if they want a chance to prevail. ■

[80] See, e.g., *Merriam*, 263 U.S. 179, 187-188, 4 AFTR 3673 (1923) ("But in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer."); *Maryland Casualty Co.*, 9 AFTR 1354, 49 F.2d 556, 558 (CA-7, 1931) ("[Tax] statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer. Such acts, including provisions of limitation embodied therein, are to be construed liberally in favor of the taxpayer. There must be certainty as to the meaning and scope of language imposing any tax, and doubt in respect to its meaning is to be resolved in favor of the taxpayer.") (citations omitted); *Bryson*, 16 AFTR 663, 79 F.2d 397, 402 (CA-9, 1935) ("It is familiar doctrine that taxing acts, including provisions of limitation embodied therein [are] to be construed liberally in favor of the taxpayer.); *Holmes Limestone Co.*, 78 AFTR 2d 96-7466, 946 F.Supp. 1310, 1319 (DC Ohio, 1996) ("These rules of construction guide this court in most situations, however, materially different rules have been adopted for the interpretation of a revenue statute . . . [A]s a special rule in tax cases, 'if doubt exists as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer.'").