Leimberg Information Services, Inc.

Steve Leimberg's Business Entities
Email Newsletter Archive Message #158

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Subject: Steve Gorin on *Hardy v. Commissioner*: Tax Court Rules for the First Time that Passive LLC Member Is Not Subject to Self-Employment Tax

"Self-employment (SE) tax does not apply to the distributive share allocable to an interest as a limited partnership in a limited partnership. In Hardy v. Commissioner, the Tax Court extended this rule to a passive member of an LLC, in this case, a surgery center owned 1/8 by the taxpayer.

Although administratively the IRS appears to be informally following its proposed regulation that defines limited partner status, CCA 201640014 makes clear that taxpayers need to use limited partnerships to maximize the possibility of refuting an IRS argument in this area. However, I prefer a limited partner structure.

On the other hand, if the net investment income tax is repealed and income from active businesses does not receive favorable tax treatment relative to passive businesses, investing in an LLC as a passive business owner, as in Hardy, may be a model that works. In that case, consider making sure that one's time spent qualifies as investor time, rather than time spent as a working owner.

I would also recommend making the person who manages the LLC be the manager. However, I remain uneasy about Hardy, because the Methvin case involved facts that in most ways were more sympathetic to the taxpayer than Hardy, yet found the taxpayer subject to SE tax. So, I am not yet convinced that one should rely on Hardy and remain firmly in favor of using limited partnerships to save SE tax."

Steve Gorin provide members with important commentary on *Hardy v. Commissioner*.

Steve Gorin is a partner in **Thompson Coburn LLP**, a law firm headquartered in St. Louis, with offices in Chicago, Los Angeles, and Washington, D.C. Steve is a nationally recognized practitioner in the areas of estate planning and the structuring of privately held businesses. Lawyers, accountants and business owners regularly look to Steve for fresh, highly knowledgeable insights into the best possible tax and estate planning approaches to their transactions. Steve crafts estate plans for individuals, keeping in mind their financial security and desire to save income and estate tax. His quarterly newsletter, "Business Succession Solutions" is considered essential reading for hundreds of CPAs, attorneys, and technically-oriented financial advisers and trust officers. **LISI** members may email Steve at sgorin@thompsoncobutn.com to obtain a free copy of over 1,200 pages of technical materials and to subscribe to his free quarterly newsletter that provides the most recent version. For information not necessarily technically oriented, visit Steve's blog at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/about. For more information about Steve, see http://www.thompsoncoburn.com/people/steve-gorin.

Here is Steve's commentary:

EXECUTIVE SUMMARY:

Code Section 1401 imposes self-employment (SE) tax, which starts at 15.3% and dips to 2.9% before increasing to 3.8%, on the business earnings of a sole proprietor or partner. SE tax is the combined employer's and employee's shares of FICA, which consists of Social Security (OASDI) and Medicare taxes.

SE tax does not apply to the distributive share allocable to an interest as a limited partnership in a limited partnership . Taxpayers have been asserting that a passive member of an LLC is not subject to SE tax. Although certain proposed regulations would support that result in certain circumstances, taxpayers had no legal authority to take that position. The Tax Court had rejected an attempt to equal an interest in a limited liability partnership (LLP) to that of a limited partner. A recent Chief Counsel Advice (CCA) seemed to accept the taxpayer's argument

for some passive LLC interests but not for other interests in the LLC involved in that CCA.

In *Hardy v. Commissioner*, the Tax Court extended limited partner treatment to a passive member of an LLC (in this case, a surgery center owned 1/8 by the taxpayer).

COMMENT:

Limited Partner Exclusion from SE Tax

A limited partner's income is not subject to SE tax, except for guaranteed payments for services rendered to a partnership that engages in a trade or business.[i]

If a person is both a general partner and a limited partner, income attributable to that person's interest as a general partner is subject to SE tax, as described in the legislative history of the statute that excludes a limited partner's self-employment income:[ii]

> 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. Under the bill the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[iii]

Prior Authority on Limited Liability Entities and the Limited Partner Exception

It is uncertain how this exclusion for limited partners applies to limited liability entities, with more than one member, that are not state law limited partnerships.[iv] Reasoning that "partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons)" were not intended to be "limited partners," *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), held that partners in a limited liability partnership (a general partnership that registers with the secretary of state to obtain limited liability for all partners) were subject to self-employment tax.[v] The court pointed out that substantially:

> all of the law firm's revenues were derived from legal services performed by [the partners] in their capacities as partners. [The partners] each contributed a nominal amount ($110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not 'earnings which are basically of an investment nature.' Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm.

Similarly, CCA 201436049 refused to apply the limited partner exception to an LLC, reasoning:

> Like the situation in *Renkemeyer*, Partners' earnings are not in the nature of a return on a capital investment, even though Partners paid more than a nominal amount for their Units. Rather, the earnings of each Partner from Management Company are a direct result of the services rendered on behalf of Management Company by its Partners. Similar to *Reither [*sic – *Riether]*, Management Company cannot change the character of its Partners' distributive shares by paying portions of each Partners' distributive share as amounts mislabeled as so-called "wages." Management Company is not a corporation and the "reasonable compensation" rules applicable to corporations do not apply.

However, CCA 201640014 treated an inactive member of an LLC as a limited partner, presumably consistent with the IRS' informal administrative

practice of following subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2:[vi]

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

On the other hand, the CCA subjected to SE tax the entire distributive share of the majority owner of the LLC, who was active in the business, rejecting his argument that the portion of his distributive share that was not attributable to his work should be excluded from SE income:[vii]

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

Proposed Regulations

In light of the ascendancy of LLCs, subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2 would define a limited partner, if ever finalized:

> **(g) Distributive share of limited partner.** An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.
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> **(h) Definition of limited partner.**
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> *(1) In general.* Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.
>
> *(2) Limited partner.* An individual is treated as a limited partner under this paragraph (h)(2) unless the individual—
>
> (i) Has personal liability (as defined in §301.7701-3(b)(2)(ii) of this chapter) for the debts of or claims against the partnership by reason of being a partner;[viii]
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> (ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[ix] or
>
> (iii) Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.
>
> *(3) Exception for holders of more than one class of interest.* An individual holding more than one class of *interest* in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

(4) Exception for holders of only one class of interest. An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

(ii) The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

(5) Exception for service partners in service partnerships. An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

(6) Additional definitions. Solely for purposes of this paragraph (h)—

(i) A *class of interest* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services

rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A *service partner* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii) A *service partnership* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv) A *substantial interest in a class of interest* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

(i) Example. The following example illustrates the principles of paragraphs (g) and (h) of this section:

Example. (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. 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 percent 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 State's law, C has the authority to contract on behalf of LLC.

(ii) *Application of general rule of paragraph (h)(2) of this section*. A is treated as a limited partner in LLC under paragraph (h)(2) of this section 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).

(iii) *Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section*. B's guaranteed payment of $6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does 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 paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section 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 under section 1402(a)(13).

(iv) *Distributive share included in net earnings from self-employment*. C's guaranteed payment of $10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's 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 paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

Because these regulations are merely proposed, however, taxpayers may either argue that they provide a reasonable position or ignore them as not yet being effective. In using them, consider the following:

- The material participation component of these proposed regulations generally would prevent a limited partner in a trade or business from reaching the sweet spot of avoiding both SE tax and the 3.8% tax on net investment income, unless one participates for more than 100 hours and no more than 500 hours.[x]

- Suppose one wants to argue that one's interest in an LLC has a general partner and a limited partner component:

    - (h)(3)(ii) requires that the individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in (h)(3)(i).

    - Limited partners described in (h)(3)(i) must hold an aggregate 20% and be described in (h)(2).

    - To be described in (h)(2), a member cannot:

        - Have personal liability for the debts of or claims against the LLC by reason of being a member;

        - Have authority to contract on behalf of the LLC; or

        - Participate in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Considering that owners of operating businesses frequently make loan guarantees, making sure that 20% of the owners are never on loan guarantees, never have authority to represent the LLC in any manner, and are active in the business only within the 101-500 hour sweet spot[xi] is a tall order.

Planning Before *Hardy*

Renkemeyer includes very strong language against granting an exclusion from self-employment tax for an active owner in an entity that is not a limited partnership, and some are concerned that *Renkemeyer* might be

extended one day to prevent limited partners in a limited partnership from excluding from SE income their distributive share as limited partners.[xii] Those who are extremely concerned about the latter might advise each partner to form his or her own S corporation to hold all of his or her interest in the business, which might simply be a straight LLC.[xiii]

In many cases, using a traditional limited partnership to govern ownership, which partnership holds one or more LLC subsidiaries that are disregarded for tax purposes, would provide more long-term flexibility regarding the conduct of future business without falling out of the protection that the proposed regulations seem to provide. If a client finds a limited partnership cumbersome to operate on a daily basis, the limited partnership could do business through one or more wholly owned LLCs that are disregarded for income tax purposes.[xiv]

Along Comes *Hardy*

Hardy v. Commissioner, T.C. Memo. 2017-16, treated as a limited partner eligible for the exclusion from SE tax a doctor who owned a 12.5% interest in an LLC, owned together with seven other doctors, that operated a professionally managed[xv] surgery center:[xvi]

> Dr. Hardy has never managed MBJ, and he has no day-to-day responsibilities there. Although he meets with the other members quarterly, he does not have any input into management decisions. He generally is not involved in hiring or firing decisions. His role and participation in MBJ have not changed since he became a member.

Contrasting Dr. Hardy's work with the lawyers practicing law in *Renkemeyer* and receiving distributive shares based on those fees from practicing law, the court pointed out:

> Dr. Hardy is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay Dr. Hardy his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital. Accordingly, Dr. Hardy's distributive shares are not subject to self-employment tax because he received the income in his capacity as an investor.

This last comment, about viewing Dr. Hardy as an investor, ties into other aspects of the case. Dr. Hardy claimed that the income from the surgery center was passive, so that he could deduct passive losses against it.[xvii] To

avoid recharacterizing the income as nonpassive, he had to prove that he spent no more than 100 hours per year on it.[xviii] The Tax Court seemed to view his quarterly meetings with other members as investor time, rather than time spent as a working owner.[xix]

Work done by an individual in the individual's capacity as an investor in an activity is not treated as participation in the activity unless the individual is directly involved in the activity's day-to-day management or operations.[xx] "Investor" work includes:[xxi]

- Studying and reviewing financial statements or reports on operations;
- Preparing or compiling summaries or analyses of the finances or operations for the individual's own use; and
- Monitoring the finances or operations in a non-managerial capacity.

When I first read the case, I had expected to see this set up as a manager-managed LLC, with the non-owner CEO being the manager under the operating agreement. I was very surprised to see the most recent annual report (viewed 3/1/2017), which said that each owner is a member-manager. Other documents from the secretary of state indicate that three doctors (not Dr. Hardy) were the initial managers in 2004; the annual reports for the years involved in the case, 2008-2010 do not clarify whether Dr. Hardy was a member or a member-manager, but they also do not list as a manager a person other than the members. Together, the court's opinion and related documentation from the secretary of state suggest that, in this LLC, the members together had exclusive legal authority to run the business. No member had more rights to run the business than any other. Their legal rights were not akin to the legal rights of a limited partner. Collectively, their legal rights were equal and were those of general partners.

Clearly, they delegated daily management to a non-owner and chose to oversee the business as mere investors, but that does not change the fact that the owners collectively had plenary legal rights to run the business on a daily basis. This looks to me like a general partnership in which the general partners agreed not to run the business themselves but rather agreed to hire staff to run the business. They are simply passive general partners. (Having limited liability does not cause one to be a limited

partner, according to *Renkemeyer*, so the LLC's liability protection is of no consequence.) The judge's opinion does not demonstrate any awareness of what Dr. Hardy's rights really were; the judge simply looked to his lack of activity. This approach appears to contradict *Methvin v. Commissioner*, T.C. Memo. 2015-81, involving an unincorporated venture in which the taxpayer had no management rights but nevertheless was subjected to self-employment tax.[xxii]

Conclusion

Although administratively the IRS appears to be informally following this proposed regulation, CCA 201640014[xxiii] makes clear that taxpayers need to use limited partnerships to maximize the possibility of refuting an IRS argument in this area. However, I prefer a limited partner structure.[xxiv]

On the other hand, if the net investment income tax is repealed and income from active businesses does not receive favorable tax treatment relative to passive businesses, investing in an LLC as a passive business owner, as in *Hardy*,[xxv] may be a model that works. In that case, consider making sure that one's time spent qualifies as investor time, rather than time spent as a working owner. I would also recommend making the person who manages the LLC be the manager. However, I remain uneasy about *Hardy*, because *Methvin* involved facts that in most ways were more sympathetic to the taxpayer than Hardy, yet found the taxpayer subject to SE tax. So, I am not yet convinced that one should rely on *Hardy* and remain firmly in favor of using limited partnerships to save SE tax.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Gorin

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CITES:

Code §§ 1402(a)(13), 303, 707(c) and 1221(a)(2); Reg. §§ 1.469-5T(f)(2)(ii)(A) and 1.469-5T(f)(2)(ii)(B); *Hardy v. Commissioner*, T.C. Memo. 2017-16, *Mursor Builders, Inc. v. Crown Mountain Apartment Assocs.*, 467 F. Supp. 1316, 1331–1332 (DC Virgin Islands 1978); *Antonic Rigging & Erecting of Mo., Inc. v. Foundry E. Ltd. Partnership*, 773 F.Supp. 420, 430 (SD Ga. 1991); *Howell v. Commissioner*, T.C. Memo. 2012-303; *Assaf v. Commissioner*, T.C. Memo. 2005-14; *Tolin v. Commissioner*, T.C. Memo. 2014-65; *Lamas v. Commissioner*, T.C. Memo. 2015-59 and *Lapid v. Commissioner*, T.C. Memo. 2004-222; Letter Ruling 9432018; [add references to articles – other than mine - here]; and various parts of Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications" (ver. 158 printed 2/26/2017), a more recent version (or that prior version) available for free by emailing the author at sgorin@thompsoncoburn.com (fully searchable PDF in excess of 1,200 pages and 11MB file size).

CITATIONS:

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[i] Code § 1402(a)(13). All references to the Code are to the Internal Revenue Code of 1986, as amended.

[ii] House Report No. 95-702, Part 1 (to accompany H.R. 7346, which became PL 95-216), October 12, 1977, p. 40, which further explained its reasons on pp. 40-41:

> 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. Under the bill the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to

guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.

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 benefits are designed to partially replace lost earnings from work.

These advertisements and solicitations are directed mainly toward public 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 their social security contributions. Many of those who invest in limited partnerships will qualify for minimum 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 cost 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 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.

[iii] Footnotes to Bishop & Kleinberger, ¶ 11.03[1][c][ii] Distinguishing limited partnership cases, *Limited Liability Companies: Tax and Business Law* (WG&L) (viewed 9/3/2016), comment:

> The 1976 version of the RULPA provided that a limited partner risked personal liability if the partner takes part in the control of the business. See, *e.g.*, *Mursor Builders, Inc. v. Crown Mountain Apartment Assocs.*, 467 F. Supp. 1316, 1331–1332 (DC Virgin Islands 1978) (limited partners liable only for debts of the partnership incurred prior to filing certificate of limited partnership); *Antonic Rigging & Erecting of Mo., Inc. v. Foundry E. Ltd. Partnership*, 773 F.Supp. 420, 430 (SD Ga. 1991) (court held that limited partner was not liable to contractor for partnership debts on the ground that limited partner participated in management). The 1985 amendments significantly changed this provision, lengthening substantially a list of safe harbors. The newest version of the Uniform Limited Partnership Act eliminates the control rule entirely. ULPA (2001), § 303.
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> ….
>
> As for ULPA (2001), the most modern uniform limited partnership act, in § 303, eliminates the control rule entirely: A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that [a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business. ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who

transacted business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner. RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:

> A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide a full, status-based liability shield for each limited partner even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

[iv] See RIA's *Fed. Tax Coord.2d* ¶A-6158. Letter Ruling 9432018 held that a member's interest generally is subject to self-employment tax. Note that the fact of limited liability is not sufficient to treat a member's interest as a limited partner interest for purposes of the Code § 469 passive loss rules. See Gorin, fn 1570. Courts have ruled against the IRS when it argued that an LLC member was a limited partner for purposes of the passive loss rules (see Gorin, fn. 1583); query whether they would treat an LLC member as a limited partner for SE tax purposes, especially when they have ruled that exceptions from SE tax are to be narrowly construed (see *Morehouse* and *Johnson* cases cited in Gorin, fn 1871).

[v] The court cited the following 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 would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. This is to exclude for coverage purposes certain earnings which are basically of an investment nature . However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership.

It then stated:

> The insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

These comments were made in the context of a partner who argued that limited liability made him the equivalent of a limited partner; the court was not addressing the status of a limited partner in a limited partnership. For an in-depth discussion, see Banoff, Renkemeyer Compounds the Confusion in Characterizing Limited and General Partners—Part 2, *Journal of Taxation*, June 2012. Part 1 was in the December 2011 issue of the Journal. See *Howell v. Commissioner*, T.C. Memo. 2012-303 (guaranteed payments from LLC were subjected to self-employment tax), initially discussed in the Shop Talk column by Banoff and Lipton, Does *Renkemeyer*'s Legacy of Confusion Live On? *Journal of Taxation* (February 2013). In their Shop Talk column, Who's a 'Limited Partner'? More Confusion Courtesy of *Renkemeyer* and *Howell*, *Journal of Taxation* (April 2013), Banoff and Lipton discussed comments, by Ronald M. Weiner, that in *Howell* the IRS merely attacked the taxpayer's characterization of guaranteed payments as not being self-employment income. They suggested that the IRS missed the boat in failing to attack as self-

employment income the taxpayer's distributive share of partnership income. *Renkemeyer* involved an LLP, whereas *Howell* involved an LLC. The authors pointed out that, in *Renkemeyer*, the partners were general partners as a matter of state law, even though they had limited liability, so the *Renkemeyer* court's analysis was much more complicated than it needed to be.

[vi] All references to "Reg." mean U.S. Treasury Regulations.

[vii] Preceding this conclusion, the CCA said (emphasis added):

> Partnership concedes that under the legislative history quoted above and the *Renkemeyer* opinion, service partners in a service partnership acting in the manner of self-employed persons are not limited partners. However, Partnership argues that a different analysis should apply to limited liability members which: (1) derive their income from the sale of products, (2) have made substantial capital investments, and (3) have delegated significant management responsibilities to executive-level employees. Partnership asserts that in these cases the IRS should apply substance over form principles to exclude from self-employment tax a reasonable return on capital invested.
>
> Partnership interprets the legislative history quoted above to mean that § 1402(a)(13) applies to exclude a partner's reasonable return on capital-investment in a capital-intensive LLC partnership, regardless of the extent of the partner's involvement with the partnership's business. In effect, Partnership interprets the sentence from the legislative history This is to exclude for coverage purposes certain earnings which are basically of an investment nature as instead meaning This is to exclude for coverage purposes all earnings which constitute a reasonable return on capital invested in a capital-intensive business. Essentially, Partnership argues that the self-employment tax rules for capital intensive businesses carried on by LLC partnerships are identical to the employment tax rules for corporate shareholder employees: only reasonable compensation is subject to employment tax. Under this analysis, Partnership argues that (1) Partnership's guaranteed payments to Franchisee are reasonable compensation for Franchisee's services, and (2) Franchisee's distributive share represents a reasonable return on

capital investments in Partnership's business, and therefore Franchisee is not subject to self-employment tax on his distributive share. Partnership argues that it would be inconsistent with the IRS's position in the Brinks case for the IRS to assert that Franchisee is subject to self-employment tax on his distributive share from Partnership.

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

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

[viii] Does this mean personal liability as an inherent state law attribute of being an owner, or personal liability because lenders require all owners to guarantee loans?

[ix] Does this mean a manager-managed LLC and the limited partner is not a manager, or member-managed with voting and nonvoting interests?

[x] See Gorin, II.I 3.8% Tax on Excess Net Investment Income, especially II.I.8 Application of 3.8% Tax to Business Income, summarized at part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[xi] See text accompanying fn. 1909 in Gorin, II.L.3.

[xii] See highlighted language fn. 1903 in Gorin, II.L.3. At least one tax expert whom I highly regard has expressed concern that *Renkemeyer* signals trouble for a limited partner in a state law limited partnership who is active. However, that expert concedes the language highlighted in Gorin, fn. 1894 very strongly supports the exclusion for an active limited partner (but not

the point that it eliminates his concern). Although I strongly disagree with that concern and feel quite confident in the structure described in Gorin, II.E.3 Recommended Long-Term Structure – Description and Reasons II.E.4 and illustrated in part Recommended Long-Term Structure - Flowchart, I leave it up to the reader to consider this expert's views.

[xiii] See Gorin, II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker (idea that S corporations block SE income), II.L.5.c Examples of S Corporation Blockers (narrative description of alternatives), and II.L.5.e LLC with S Corporation as Blocker (diagram)

[xiv] See Gorin, II.B Limited Liability Company (LLC), especially the comments accompanying fns. 227-238, discussing when a single-member LLC is or is not disregarded.

[xv] The court pointed out:

> MBJ hires its own employees and does not share any employees with Northwest Plastic Surgery. Like hospitals, MBJ directly bills patients for facility fees. MBJ then distributes to each of its members his or her share of the earnings based on the facility fees less expenses. MBJ uses a third-party accounting firm to prepare the Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., for the members. MBJ does not pay physicians for their procedures.

[xvi] The IRS' post-trial brief pointed out that the members approved an employee termination at the CEO's request, but the transcript indicated that was an unusual situation and that the CEO usually took care of employment issues without consulting the members as an ownership group.

[xvii] The IRS tried to require Dr. Hardy to group his activity in his medical practice with his activity in the surgery center, but the Tax Court held that his decision not to group the two activities was reasonable. See Gorin, II.K.1.b Grouping Activities.

[xviii] See Gorin, II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[xix] See Gorin, II.K.1.a.v What Does Not Count as Participation.

[xx] Reg. § 1.469-5T(f)(2)(ii)(A) provides:

> *In general*. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

When an individual is involved in day-to-day management or operations, does investor work done in furtherance of such management/operations count, or does all of the investor work count, without needing to differentiate between work done purely as an investor from investor work done to conduct such management/operations? All the investor work counts, once the court finds that the individual is involved in day-to-day management or operations. *Assaf v. Commissioner*, T.C. Memo. 2005-14; *Tolin v. Commissioner*, T.C. Memo. 2014-65; and *Lamas v. Commissioner*, T.C. Memo. 2015-59.

[xxi] Reg. § 1.469-5T(f)(2)(ii)(B). *Lapid v. Commissioner*, T.C. Memo. 2004-222, held:

> While Mrs. Lapid testified that she spent many hours every night studying and tracking her investments, the evidence she submitted shows that she was actually just reviewing financial statements and reports on operations. Because the regulation specifically defines such monitoring as investment activity, we cannot include that time in calculating whether she met the material participation standard in three of the safe harbors she is aiming for. This is true despite our belief that Mrs. Lapid did indeed spend a lot of time tracking her properties….
>
> Unable to count the hours that Mrs. Lapid spent on investment activity, the petitioners' claim to the loss on their hotel condos quickly collapses. Though we believe that the Lapids did at least occasionally visit the condos, the record is devoid of any evidence that they spent anywhere near 500 hours doing so. That the hotels did the routine onsite work of property management undermines the Lapids' ability to show any significant amount of time that would count as "participation" in the activity. And they completely failed to

compare the time they spent with the time spent by individuals actually onsite.

[xxii] See fn. 1867, found in part II.L.1.a.i General Rules for Income Subject to Self-Employment Tax.

[xxiii] Particularly note vii and the accompanying text.

[xxiv] Described in Gorin, II.E.3 Recommended Long-Term Structure – Description and Reasons and II.E.4 Recommended Long-Term Structure - Flowchart

[xxv] The text surrounding fn. xv discusses *Hardy*.