NEW YORK STATE BAR ASSOCIATION
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November 14, 2011

The Honorable Emily S. McMahon
Deputy Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Dear Ms. McMahon, Mr. Wilkins and Mr. Schulman:

We are pleased to submit the New York State Bar Association's Report No. 1247 relating to the application of the self-employment tax imposed under Section 1401[1] and the related exclusion from such tax set forth in Section 1402(a)(13) for certain members of entities classified as partnerships for U.S. federal income tax purposes. Specifically, the report

[1] All section references in this letter are to the Internal Revenue Cod). e of 1986, as amended, or the Treasury regulations promulgated thereunder.

requests guidance regarding the meaning of the term "limited partner" for purposes of Section 1402(a)(13) and sets forth our recommendations on this subject. The attached report also comments on the application of the 3.8% tax imposed under Section 1411 on an individual fund manager's distributive share of capital gain or other investment income attributable to a "carried interest" in a private equity fund, hedge fund, or other investment partnership.

The subject of "payroll" taxes in relation to members of entities classified as tax partnerships drew much attention this year, mostly in reaction to the Tax Court's decision in Renkemeyer, Campbell & Weaver LLP v. Commissioner.[2] As discussed in the attached report, however, this issue is not new. Many years have passed since regulations were first proposed under Section 1402(a)(13) (the "Proposed Regulations")—those Proposed Regulations were never finalized and were the subject of a temporary moratorium. Though the moratorium expired over fourteen years ago, the Proposed Regulations have not been finalized, or withdrawn, and open questions remain under Section 1402(a)(13) in terms of the scope of the exclusion from self-employment taxes for "limited partners". At the same time, limited liability companies and limited liability partnerships have proliferated -- allowing members to retain a limited liability shield while participating in a very active way in the operation, and often in the management, of an enterprise formed as a tax partnership.

The recently-enacted provisions of Section 1411 will impose a 3.8% tax on income that represents a "return on invested capital" for individuals who meet a certain income threshold. This statutory provision was designed to parallel the Medicare tax imposed on "earned" income. We believe that the need for guidance in respect of Section 1402(a)(13) has been heightened, given the adoption of Section 1411.

As reflected in the attached report, in our view the term "limited partner" for purposes of Section 1402 should be divorced from state law classifications. We recommend that in order to best reflect the Congressional intent underlying the Section 1402(a)(13) exclusion, the term "limited partner" should be defined by reference to the level of participation of an individual in relevant partnership activities. A test that is analogous to the material participation test that applies under Section 469 of the Code would in our view further the intent of the self-employment tax provisions of the Code, and would be consistent with Congress' goal in enacting the statutory provisions contained in Section 1411. The attached report takes the Proposed Regulations as a starting point and makes a number of specific recommendations in respect of a "material participation" standard, special rules for service partnerships, the manner in which "service partnership" should be defined, and the extent to which a partner who holds interests denominated (under state law) as both "general" and "limited" partner interests should be allowed to bifurcate

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[2] Renkemeyer, Campbell & Weaver LLP v. Commissioner, 136 T.C. No. 7 (Feb. 9, 2011

their interest in the relevant partnership for purposes of the self-employment tax provisions of Section 1401.

In relation to Section 1411, we ask that consideration be given to the issuance of some form of guidance that will address the application of the new statutory provision in the context of investment partnerships, especially where there an individual derives income through more than one partnership tier. We make this observation because we have noted certain ambiguities that could arguably be read into the statutory provisions, particularly in relation to investment partnerships and the carried interest.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,

Jodi Schwartz
Chair

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