NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON THE APPLICATION OF EMPLOYMENT TAXES TO PARTNERS AND ON THE INTERACTION OF THE SECTION 1401 TAX WITH THE NEW SECTION 1411

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Report 1247

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMENTS ON THE APPLICATION OF EMPLOYMENT TAXES TO PARTNERS AND ON THE INTERACTION OF THE SECTION 1401 TAX WITH THE NEW SECTION 1411 TAX[1]

This report of the New York State Bar Association Tax Section (the "Report") addresses the application of self-employment and Medicare taxes to individual members of entities classified as partnerships for federal income tax purposes. More specifically, this Report focuses on the need for guidance regarding (i) the meaning of the term "limited partner" for purposes of Section 1402(a)(13),[2] in order to address the application of the tax imposed by Section 1401 to a non-general partner's share of earnings from an entity classified as a partnership, and (ii) the application of the 3.8% Medicare contribution tax imposed by 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.[3]

The general topic of how the Section 1401 self-employment taxes apply to members of entities classified as partnerships for federal income tax purposes (including limited partnerships ("LP"s), limited liability partnerships ("LLP"s) and limited liability companies ("LLC"s)) has

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[1] The principal drafters of this report were Lee Allison and Elizabeth Kessenides. Substantial contributions were made by Jodi Schwartz, Andrew Needham, Diana Wollman, David Schnabel, Andrew Bloom, Jesse Jacobsen, Jesse White and Sara Clevering. Helpful comments were received from Willard Taylor, Michael Schler, Vadim Mahmoudov and James Brown. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] All Section references contained herein are, unless otherwise indicated, to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Section 1411 was adopted as part of the Health Care and Education Reconciliation Act of 2010; it imposes a 3.8% Medicare contribution tax on certain individuals, estates and trusts with respect to "net investment income." Section 1411 is discussed in more detail later in this Report. The term "investment partnership" is not used in Section 1411. Rather, "investment partnership" is a term we use herein to refer to a partnership that issues an "investment services partnership interest," as that term is defined in proposed legislation contained in Section 412 of the American Jobs Act of 2011, S. 1549 (2011).

received much attention this year due to the Tax Court's decision in Renkemeyer, Campbell & Weaver LLP v. Commissioner.[4] While the Renkemeyer decision renewed focus on the subject of how these taxes apply to individual members and partners who are not "general partners" under State law, the issue is not new; in fact, for many years there has been a lack of definitional clarity as to the meaning of the term "limited partner" in Section 1402(a)(13), as well as a lack of guidance regarding how this definition relates, if at all, to the determination of whether one is a "material participant" for purposes of Section 469 (the applicable provisions of which limit the deductibility of losses from passive activities).

The matter has become more complicated as a result of the recently-adopted statutory provisions contained in Section 1411 of the Code. Under Section 1411, certain passive or "unearned" income of individuals will be subject to a 3.8% "Medicare contribution" tax beginning in January 2013 (the "Section 1411 Tax").[5] The Section 1411 Tax was specifically designed to parallel the uncapped Medicare hospital insurance portion of FICA and SECA taxes[6] which apply to "earned" income. When the legislation was proposed and passed, it was observed that people who earn a salary or who earn "self employment income" must pay the Medicare hospital insurance tax on that earned income; one of the Administration's goals, in proposing Section 1411, was to provide for increased fairness.[7] The passage of Section 1411

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4 Renkemeyer, Campbell & Weaver LLP v. Commissioner, 136 T.C. No. 7 (Feb. 9, 2011).

5 Technically revenue collected under the Section 1411 Tax can be spent on expenses other than Medicare expenses. STAFF OF THE JOINT COMMITTEE ON TAXATION, DESCRIPTION OF THE SOCIAL SECURITY TAX BASE, June 21, 2011, p. 24.

6 The terms FICA and SECA are defined in the beginning of the background section below.

7 *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE RECONCILIATION ACT OF 2010, March 21, 2010 ("JCT Paper March 2010") pp. 134-136. See also The White House, "The President's Proposal" (Feb. 22, 2010), http://www.whitehouse.gov/sites/default/files/summary-presidents-proposal.pdf (last visited Aug. 30, 2011).

thus reflects an intention to impose the 3.8% Medicare tax on both earned and unearned income of individuals, assuming a certain income threshold is met. This evolution in the law further underscores the need for clarification regarding the application of Section 1401 (including its application to a "limited partner").

As things currently stand, application of the Section 1401 tax to an individual's share of business income derived by an entity classified as a partnership for tax purposes can vary greatly based upon the state law form of entity that is selected and the state law classification of the individual's interest; this variation is, in our view, not appropriate.[8] We believe that the Section 1401 tax imposed on individual partners performing similar activities should be similar and should not vary based upon state law classifications. We believe that if the principles underlying the FICA and SECA Medicare tax on salaries and self-employment income are to be properly reflected, the Section 1401 tax must be applied in a consistent fashion to all partners in LPs, LLPs and LLCs.

We see these issues as being closely linked to certain open questions concerning the application of the Section 1411 Tax. The statutory text of Section 1411 may raise questions of interpretation, particularly in the context of partnerships that are principally engaged in investment activities (including investing in stocks, securities, and other financial instruments). Some of these interpretive questions might allow room for an interpretation whereby certain passive income derived through a partnership would avoid taxation under both Section 1401 and Section 1411, a result that we do not believe was intended. We believe it would be helpful if

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[8] The NYSBA Tax Section submitted Report No. 1218 last September, "Report on Legislative Proposal Regarding Employment Taxes and Professional Service Business" (the "2010 NYSBA Report") on the proposal introduced in the House of Representatives regarding the application of employment taxes to professional service businesses conducted through partnership entities and S corporations. That legislative proposal would have addressed a broader universe of business entities, including S corporations. This Report, in contrast, is focused on the question of what regulatory guidance can be issued within the current statutory framework of Section 1402 and Section 1411.

clarifying guidance were issued under Section 1411 making the operative provisions of the statute clearer in the context of investment partnerships and tiered ownership structures.

In terms of the Treasury Department's authority to issue regulations defining the meaning of the term "limited partner" for purposes of Section 1402(a)(13), taking the regulations that were proposed by the Service in 1997 as a starting point,[9] we believe that the Treasury Department clearly has the authority to issue interpretive regulations that would include analogous provisions to the 1997 Proposed Regulations, particularly in light of the decision of the Supreme Court in Mayo Foundation for Medical Education vs. United States.[10] In particular, we believe the Treasury Department unquestionably has the authority to issue regulations addressing the circumstances where a member of an entity formed as other than a "limited partnership" under state law could nevertheless be treated as a "limited partner" for purposes of Section 1402(a)(13), since there are categories of interests a person might hold that are exactly what was envisioned when the exception in Section 1402(a)(13) was adopted. Similarly and by extension, we believe the Treasury Department has clear authority to exclude certain persons from "limited partner" treatment for this purpose, regardless of the manner in which their interest is denominated under applicable state law, because there are cases where a person's level of involvement and/or participation in a partnership goes beyond what Congress was referring to and had contemplated when drafting the exclusion now contained in Section 1402(a)(13). We address the subject of the Treasury Department's authority to issue interpretive regulations in greater detail in the section at the end of this Report.

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[9] Prop. Treas. Reg. Section 1.1402(a)(2), REG-209824096 (1/13/1997).

[10] 131 S. Ct. 704 (2011).

Background

Under current law, taxes are imposed on wages (i.e., income from employment by an employer) under the Federal Insurance Contribution Act ("FICA") and on earnings from self employment under the Self-Employment Contributions Act ("SECA"). These two taxes are essentially parallel: FICA has two components; a 12.4% tax on wages, up to a cap, and a 2.9% tax on wages which is uncapped.[11] Half of the FICA tax is a tax liability of the employee, which is not deductible by the employee, and the other half of the FICA tax is a tax liability of the employer, which is deductible by the employer. SECA also has two components: a 12.4% tax on income from self employment (specifically, "net earnings from self-employment" ("NESE") up to a cap, and a 2.9% tax on NESE that is uncapped.[12] To replicate the deduction permitted to the employer for one-half of FICA, self-employed individuals can deduct one-half of their SECA tax in calculating adjusted taxable income.[13] It is worth observing that the 2.9% uncapped portion of both the FICA tax and the SECA tax, both of which are set to increase to 3.8% starting January 1, 2013 for taxpayers above a certain income threshold, is what the drafters of Section 1411 had in mind when they enacted that provision in 2010—Section 1411 imposes a comparable 3.8% tax on unearned income (i.e., income that is not wages and is not from self employment).[14]

For individuals who are partners, the relevant tax under current law is SECA. (FICA does not apply to a partner's partnership income because, as the Service has ruled, a partner

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[11] *See* Section 3101(a) and Section 3111(a).

[12] The 12.4% tax is referred to as the old age, survivors, and disability insurance tax and cap is currently $106,800); the 2.9% tax is referred to as the Medicare hospital insurance tax.

[13] A detailed description of employment taxes under current law can be found in STAFF OF THE JOINT COMMITTEE ON TAXATION, DESCRIPTION OF THE SOCIAL SECURITY TAX BASE, June 21, 2011.

[14] JCT Paper March 2010 at pp. 134-136.

cannot be an employee of her own partnership.[15]) NESE is defined in Section 1402(a) and generally includes an individual's distributive share of income from any trade or business carried on by a partnership in which she is a partner. An important exception to this general rule is set forth in Section 1402(a)(13), excluding from NESE "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) . . . 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."

Congress enacted Section 1402(a)(13) in 1976 in order to prevent individuals not otherwise covered by Social Security from obtaining such coverage by purchasing limited partnership interests in partnerships which they had no other connection to.[16] Thus, Section 1402(a)(13) carves out from NESE (and thus from the scope of SECA) a *limited partner's* distributive share of partnership income. It has remained open to interpretation for years whether the (a)(13) exclusion applies to LLC members, who are neither general nor limited partners, but who benefit from the protection of limited liability under state laws; given the statutory reference to "limited partner," it is unclear what criteria are to be applied when making this determination.

In January 1997, the Service proposed regulations (the "1997 Proposed Regulations") that would have clarified the intended scope of Section 1402(a)(13); these proposed regulations would generally have prevented any partners (including LLC members) providing more than 500 hours of service to the partnership (and, in the case of service partnerships, more than a de minimis amount of services) from being treated as "limited partners" for Section 1402(a)(13)

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[15] Rev. Rul. 69-184, 1969-1 C.B. 256.

[16] *See* H.R. REP. NO. 95-702(I), pp. 40-41 (1977) (This report addressed P.L. 95-21, "Social Security Amendments of 1977"). *See also* William L. Raby & Burgess J.W. Raby, "Self-Employment Income of LLC 'Partners'," 2003 TNT 108-49 (June 5, 2003).

purposes. However, following the release of the 1997 Proposed Regulations, Congress imposed a one-year moratorium, in August 1997, preventing the Treasury from adopting regulations dealing with the employment tax treatment of limited partners (the "1997 Moratorium").[17] The moratorium expired on July 1, 1998. The 1997 Proposed Regulations were never adopted, even after the 1997 Moratorium expired.

Accordingly, taxpayers have lacked guidance regarding the scope of subsection (a)(13). We do not believe Congress intended the application of the self employment tax to depend upon formalistic differences in the choice of entity selected, but the current statutory framework, read alone, allows for such distinctions. We recommend now, as we have previously, that all individuals who perform services for flow-through entities should be treated consistently under the SECA rules. We believe this is consistent with Congressional intent (as discussed in more detail below). Accordingly, we recommend that regulatory guidance be issued providing that SECA treatment of partners depends upon whether they perform services for the "partnership," and not on whether they hold an interest denominated as a LP, LLC member, or GP interest.

To some degree, a complete rationalization of the FICA/SECA tax treatment of owners of flow-through entities would require some legislative changes to the S corporation rules. Currently, a n S corporation shareholder is subject to FICA only on the shareholder's wages from the S corporation, and not on amounts received in the form of dividends. This dichotomy puts pressure on the question of whether the shareholder/service-provider was reasonably compensated in the form of wages (an inquiry that is not relevant in the SECA-partnership context). In this Report, we are not addressing S corporations, other than to reiterate that last

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[17] H.R. 2014 Sec. 734 (1997) on Sec. 935 "Moratorium on certain Regulations," Taxpayer Relief Act of 1997, P.L. 105-34.

year we endorsed the proposed reform of the SECA rules as applied to S corporation and certain other flow through entities (included in HR 4213).[18]

We believe the time is ripe for regulatory guidance under Section 1402. Section 1402(a)(13) was enacted (in 1976) in reaction to the result of Estate of Ellsasser.[19] The new section was intended to prevent "purely passive" limited partners from attempting to come within the social security tax system. In fact, the House Report at the time expressed concern, when the provision was first enacted, over "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 limited partner 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 . . . *inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.*" (emphasis supplied).[20] The legislative history thus reflects a clear intention on Congress' part to have the self employment tax apply to "earnings from work."[21]

Much has changed since the original enactment of Section 1402(a)(13). At that time, limited partners generally acted as purely passive investors. State partnership laws and the structure of LP and LLC operating agreements have evolved a great deal. Today, many state

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[18] *See* NYSBA 2010 Report.

[19] 61 T.C. 241 (1973). In Ellsasser, the Court held that the statutory language, pre-Section 1402(a)(13), required an individual who was a limited partner and provided only capital to the partnership to pay self employment tax on his share of the distributive income of the partnership. "As a limited partner, Ellsasser received a share of . . . profits. The amount of such share was determined in part by the ratio of his capital contribution to the total capital contributed by all of the limited partners. . . . The general partners received a larger percentage of the profits than did the limited partners on account of their active participation in the business. Regardless, it was recognized that capital was essential to the operation of [the partnership]." *Id.* at 243.

[20] H.R. REP. NO. 95-702(I), pp. 40-41 (1977) (emphasis added).

[21] The Tax Court also pointed this out in Renkemeyer at 89.

partnership laws provide an expansive scope of "permissible" activities for limited partners and LLC members—and operative documents often allow limited partners and LLC members to provides services to the partnership, vote on matters, guarantee debts of the partnership, and even own general partner or managing member interests.[22] We now also have LLPs, entities which are essentially the same as general partnerships but for the fact that a partner's specific personal liability for partnership debts is limited, to some extent, under applicable state law.[23] The use of LLCs and LLPs, as compared to limited partnerships, has increased significantly—both allow members to combine flow-through taxation with some limited liability shield and active participation in the operations of the enterprise

Despite these developments, there has been no binding guidance since Section 1402(a)(13) was initially enacted in 1976 (over 35 years ago). The issuance of the 1997 Moratorium and the 1997 Proposed Regulations remaining untouched, in proposed form, have left taxpayers with little guidance beyond the text of Section 1402(a)(13) and confusion as to why no guidance has been issued. This lack of guidance became "front-page news" when the Renkemeyer decision was issued earlier this year. In that case, members of a limited liability law firm partnership, a LLP, took the position that the Section 1402(a)(13) exclusion applied to their distributive share of partnership income because the organizational documents characterized their interests as LP interests and because under state law they had limited liability protection. The Tax Court stated:

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[22] *See, e.g.*, DEL. CODE ANN. tit. 6 § 17-302, 303 (2011); N.Y. P'SHIP LAW § 121-108, 302 (McKinney 2011); 1953 N.Y. Op. Att'y Gen. 193.

[23] *See* generally, Amy S. Elliott, "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," 2011 TNT 48-3 (Mar. 11, 2011); Martin A. Sullivan, "Economic Analysis: Renkemeyer Annual Cost to Partners Could Exceed $1 Billion," 2011 TNT 55-2 (Mar. 22, 2011); Clarence G. Kehoe et al., "Renkemeyer Article Rankles Attorneys, Accountants," 2011 TNT 74-9 (Apr. 18, 2011); Monte A. Jackel, "Has Politics Trumped Policy?," 2011 TNT 94-8 (May 16, 2011).

> "'Limited partner' is a technical term which has become obscured over time because of the increasing complexity of partnerships and other flow through entities as well as the history of Section 1402(a)(13). We therefore must look to the legislative history for guidance. . . . The legislative history of Section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who perform 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."[24]

We describe below a few examples of situations where we believe taxpayers take varying positions as to the application of the Section 1402(a)(13) exclusion:

Situation 1:

- Individuals X, Y and Z operate a medical firm as a LLC under State law, classified as a partnership for federal tax purposes. Each of X, Y and Z is a doctor performing medical services for the LLC. X, Y and Z each contribute $10 in exchange for a 33.33% membership interest (in both capital and profits) in the LLC. X is the only managing member of the LLC. The LLCs entire income consists of revenue from the provision of medical services by X, Y and Z. Do Y and Z's entire distributive shares constitute NESE, considering that Section 1402(a)(13) references "limited partners"?

Situation 2:

- Individuals X, Y and Z operate a law firm as a LLP under State law, classified as a partnership for federal tax purposes. Each of X, Y and Z is an attorney performing legal services for the LLP. X, Y and Z each contribute $10 in exchange for general managing partnership interests (a 3% economic interest in the LLP in the aggregate) and $970 in exchange for limited partnership interests (representing a 97% interest in the LLP, in the aggregate, evenly split among the partners). The LLP's sole income consists of revenue from the provision of legal services by X, Y and Z. Situation 2 resembles the fact pattern litigated and addressed by the Tax Court in Renkemeyer. The question that arises in relation to self-employment tax is whether the Section

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[24] Renkemeyer, *supra* note 4, at 89.

1402(a)(13) exclusion applies to the distributive share of partnership income that is allocable to a limited partner interest in this context.

Situation 3:

- Individuals X and Y have economically equivalent ownership interests in a business Z that provides architectural services. Z is formed as a LP under State law, classified as a partnership for federal tax purposes. X is the limited partner, and Y is the general partner. X spends more than 500 hours per year working as an architect for Z. X takes the tax position that X materially participates in Z and is therefore not subject to the passive activity loss limitation of Code Section 469. In Year 1, Z has a net loss. X deducts the allocable share of Year 1 net loss against ordinary income. In Year 2 the business has net income of $100, and Z pays a salary of $5 to X. X pays self-employment tax on $5 (treating it as a guaranteed payment for services) but takes the position that X's allocable share of Year 2 partnership income is not subject to such tax.

We have recommended in various reports submitted over the years that uniform rules should be adopted, across the board, for all flow-through entities.[25] This Report comments on the nature of the guidance that could be issued under Section 1402(a)(13) in order to achieve a rationalization of the tax results in these situations. We believe that our recommendations, if adopted, would better achieve the intended purpose of the SECA tax and make its application fairer across similar enterprises. We make certain specific recommendations that expand upon the recommendations made in the 1997 NYSBA Report addressing the 1997 Proposed Regulations.

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[25] *See* NYSBA Tax Section Report "Report on the Self-Employment Tax as Applied to Owners of Interests in Pass-Through Entities," December 9, 1994 (the "1994 NYSBA Report"), NYSBA Tax Section report "Comments on Self-Employment Regs," March 27, 1997 (the "1997 NYSBA Report"), NYSBA Tax Section Report "Comments on JCT Recommendation Relating to Employment and Self-Employment Taxes of Partners, LLC Members and S Corporation Shareholders" (the "2005 NYSBA Report"), September 23, 2005 and the 2010 NYSBA report.

The discussion that follows is divided into four parts:

1. A summary of our recommendations.
2. A detailed discussion and analysis of our recommendations regarding Section 1402(a)(13) and the term "limited partner."
3. A discussion and analysis of the interaction between Section 1402(a)(13) and Section 1411, and recommendations for clarifying guidance that may be needed in relation to the scope of Section 1411, particularly in relation to investment partnerships.
4. A discussion regarding the Treasury Department's authority to issue interpretive regulations defining the term "limited partner" for purposes of Section 1402.

1. Summary of Recommendations.

The Report makes the following recommendations:

A. **Definition of "Limited Partner" for Purposes of Section 1402(a)(13)**: Adopt a "**Material Participation**" standard analogous to that of Section 469. Regulations should be issued under Section 1402 delineating the meaning of the phrase "any item of income or loss of a limited partner" contained in subsection (a)(13). We recommend that the regulations give no weight to state law classifications; instead, we recommend that the distinction between "limited partner" and someone *other than a limited partner* for purposes of (a)(13) be determined pursuant to a test that looks at what the individual actually does; we recommend using guidelines similar to those contained in the "material participation" rules of Temporary Treasury Regulations Section 1.469-5T(a). In the case of a "service partner" in a "service partnership" (terms we discuss below), we recommend that all of the income or loss of that service partner attributable to the provision of services by the partnership (whether or not by that partner) not be treated as "income or loss of a limited partner" for purposes of Section 1402(a)(13).

B. **Definition of "Service Partnership" and "Service Partner."** Given our recommendation above, regulatory guidance will need to define the terms "service partnership" and "service partner." We generally support the definition used in the 1997 Proposed Regulations, which focused on certain enumerated businesses that are not capital-intensive enterprises, but would eliminate the requirement that "substantially all" of the partnership's activities involve the performance of the relevant services. We also recommend that consideration be given to including other non-capital intensive businesses within the scope of "service partnerships."

C. **Bifurcation Issues**. We make certain recommendations regarding situations where a person might hold multiple classes of interests. In the case of service partnerships, we generally do not support bifurcation; rather, we recommend that a service partner's distributive share of income from a service partnership attributable to the provision of services by that partnership be treated as income of a "general partner," regardless of whether that service partner holds different classes of interests for state law purposes. In the cases involving "non-service" partnerships, interests that are identical to those held by a person who is not a "material participant" could be treated as "limited partner" interests, recognizing that income attributable to such interests should then be subject to the tax imposed by Section 1411.

D. **Tiered Structures**. Special provisions should be included to address, to the extent possible, tiered partnership structures, particularly where a member of an upper tier partnership materially participates in the activities of a lower tier partnership.

E. **Retired Partners**. Any guidance should make clear that the provisions will not override the exception contained in Section 1402(a)(10) for retired partners.

F. **Application of Section 1411 to Investment Partnerships**. Future regulations or other guidance should clarify that, subject to certain limited exceptions, all net income allocable to the carried interest of a typical investment partnership that otherwise constitutes "net investment income" should be subject to tax under Section 1411 without regard to whether such individual (or any upper-tier partnership of which such individual is a member) is engaged in a trade or business and without regard to whether such individual "materially participates" in that trade or business.

2. Discussion and Analysis: Guidance Under Section 1402(a)(13).

A. Meaning of the Phrase "Income or Loss of a Limited Partner"; the Material Participation Standard Contained in Section 469.

As stated above, NESE is defined in Section 1402(a) as the gross income derived by an individual from any trade or business carried on by such individual, less deductions attributable to such trade or business, plus such individual's distributive share (whether or not actually distributed) of income or loss described in Section 702(a)(8) from any trade or business carried on by a partnership of which he is a member. Section 1402(a)(13) excludes from NESE the distributive share of any income or loss of a "limited partner," except for guaranteed payments described in Section 707(c) (to the extent that those payments are established to be in the nature of remuneration for those services). As discussed above, the lack of regulatory guidance under Section 1402(a)(13), combined with the fact that limited partners can generally perform a greater level of services than was envisioned when Section 1402(a)(13) was enacted, has led to a significant need for Section 1402(a)(13) guidance. Equity interests in LLPs and LLCs can share attributes of both general partnership interests (i.e., management powers) and limited partnership interests (i.e., limited liability), making their Section 1402(a)(13) treatment uncertain. Uncertainty may also result when an individual holds both a general partner and a limited partner interest in the same entity.[26] In each of these cases, tax outcomes wholly unrelated to the nature of the actual activities of the taxpayer can arise. The NESE definition appears to have lost its connection to its intended meaning: "earnings from work."

Treasury's most thorough attempt to address the above-described issues was reflected in the 1997 Proposed Regulations, which were never finalized.[27] The 1997 Proposed Regulations would have compelled a partner to be treated as a "non-limited partner"[28] if:

(i) she had personal liability for debts or claims against the partnership by reason of being a partner (the "personal liability" test);[29]

(ii) she had authority to contract on behalf of the partnership (the "power to bind" test);[30] or

(iii) she participated in the partnership's trade or business for more than 500 hours during the partnership's taxable year.[31]

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[26] Renkemeyer, at 84.

[27] As mentioned above, these regulations were not ultimately adopted, and were the subject of the Moratorium. *See* H.R. 2014, Sec. 734 (1997).

[28] It should be noted that neither Section 1402 nor the 1997 Proposed Regulations use the term "general partner." The provisions in Section 1402(a) simply refer to a distributive share of income from a partnership in which one is "a member"; the provisions of (a)(13) refer to limited partner, and the regulations describe cases where one will not be treated as a "limited partner." Thus, in our discussion herein we will often refer to a non-LP class of interests.

[29] Prop. Treas. Reg. §1.1402(a)-2(h)(2)(i).

[30] Prop. Treas. Reg. §1.1402(a)-2(h)(2)(ii); see also the 1997 NYSBA Report at para. 22-24.

We recommend returning to the underlying goal of the SECA tax and the Section 1402(a)(13) exception by focusing on whether the partner's distributive share of income represents earnings from work.[32] We recommend, as we did in the 1997 NYSBA Report, that the term "limited partner" for purposes of subsection (a)(13) be based on the activity level of the relevant partner/member and not on the title, or nomenclature, that applies for state law purposes. Thus, we also would not repropose the personal liability test or the power to bind test, as these do not depend upon whether the partner is providing services to the partnership. We would instead follow the approach of the third test above, but with certain modifications.

Specifically, we recommend that the term "limited partner" generally be defined in a manner consistent with the principles that govern in the material participation test of Section 469,[33] but with certain specific modifications we recommend below. If our recommendation were to be adopted, the term "limited partner" for SECA purposes would exclude any partner who "materially participates" in the partnership's trade or business. A similar approach was recommended by the Joint Committee of Taxation in 2005 for determining whether partners (and S corporation shareholders) would be subject to SECA taxes.[34] Under Temporary Treasury Regulations Section 1.469-5T(a), an individual is considered to materially participate in an activity for the taxable year only if:

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[31] Prop. Treas. Reg. §1.1402(a)-2(h)(2)(iii). An exception to this rule applies under Prop. Treas. Reg. Section 1.1402(a)-2(h)(4), where a LP interest is identical to that of other non-service providing members of the partnership.

[32] We enunciated this same view in our 1997 report on the Proposed Regulations. *See* 1997 NYSBA Report at paras. 11-12 and 16.

[33] Prop. Treas. Reg. §1.1402(a)-2(h)(2)(iii).

[34] JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 95-104 (January 27, 2005). In our 2005 NYSBA Report we supported this approach, with some questions regarding whether it was appropriate to apply Section 469's look back rules (Prongs (5) and (6) of the material participation test, discussed below) to SECA taxes, which are meant to tax income earned from "actually working."

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners) for such year;

(4) The activity is a "significant participation activity" (as defined in Treas. Reg. 1.469-5T(c)) for the taxable year, and the individual's aggregate participation in all "significant participation activities" during such year exceeds 500 hours;[35]

(5) The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a "personal service activity," and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.[36]

We believe that some modifications to the Section 469 Temporary Treasury Regulations test are appropriate in the context of Section 1402. First, the Section 469 Temporary Treasury Regulation "materially participation" test is modified in the case of a "limited partners," a term defined in Temporary Treasury Regulations Section 1.469-5T(e)(3) by reference to either state law limitations on liability or the partnership's designation of the interest in its organizational documents. If one is a limited partner, she is, for Section 469 purposes, considered to *materially participate* in an activity only by satisfying prongs (1), (5), or (6) of the test enumerated above. We do not believe the same approach should be adopted in the Section 1402 context. We

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[35] The "significant participation activity" concept could be very meaningful in the Section 1402 context. As we discuss below, we recommend some type of aggregation rule is appropriate in the Section 1402 context so that the relevant application of the SECA tax is not avoided through structures whereby taxpayers set up multiple 'series' of partnership entities. *See* discussion, *infra* p. 16.

[36] Temp. Treas. Reg. §1.469-5T(a).

recommend that for purposes of Section 1402(a)(13), no distinctions be drawn based upon state law classifications or limitations on liability. Rather, the general 7-prong test for material participation set forth above should apply across-the-board to any partner or member.

Second, Temporary Treasury Regulation Section 1.469-5T(a)(4) refers to the concept of a "significant participation activity." This concept is designed to take into account a situation where a taxpayer participates in multiple trade or business activities (possibly through more than one entity), in each case for 100 hours or more; where the aggregate amount of participation in such activities exceeds 500 hours, the taxpayer is treated as material participating in each. We believe a variation on this test makes sense in the context of defining "material participation" for purposes of Section 1402—in fact, we recommend that a broader "aggregation" test be adopted in this context. We recommend a broader aggregation test because we believe it is common in many business contexts for partnership entities that are related to establish "series" entities, brother-sister type entities, or entities under common control, but with some variation in the composition of the outside investors. With this in mind, we recommend that an activity should constitute a "significant participation activity" if the taxpayer participates in the activity for more than a de minimis amount of time, and the taxpayer's total participation in the activities of entities *that are under common management or control* exceeds 500 hours.

This approach will require some articulation of the measure for ascertaining when entities will be considered to be under "common management or control"; for this purpose, a test could take into account overlapping equity ownership of the voting power or value of the relevant entities' equity interests, or both. For example, an assumption could be made that if a certain percentage of the equity value of two or more entities is held by the same persons, they are under common control. A separate test could apply, independent of the ownership of equity value, that examines “common control” of two or more enterprises by reference to voting power or by reference to board composition. By way of analogy, under Section 280G a change in effective control of an entity is deemed to occur if any one person or persons acting as a group acquire stock possessing 20% or more of the voting power of a corporation.[37] A similar approach might be appropriate in this context, examining the effective control of various entities by reference to overlap in ownership of voting power or a certain threshold of overlap in board composition. Such a 20% overlap threshold would seem to be a sufficient amount of overlapping ownership to merit an aggregation of activities for purposes of the “significant participation activity” measure we refer to here.

The modifications we propose above to the existing definition of material participation under Section 469 would tend to expand the universe of taxpayers who are deemed to be “material participants” for purposes of Section 1402. We believe this is appropriate for a few reasons. Under Section 469, meeting the “materially participation” test will tend to reduce the individual’s tax liability (by avoiding a provision that prohibits the use of partnership losses to shelter income from other sources). In this context, therefore, taxpayers have every incentive to satisfy the definition of material participation (and therefore would be unlikely to divide their services among different related partnerships in an effort to avoid qualifying as a “material participant”). Under Section 1402, however, a taxpayer who meets the materially participation test will tend to increase her tax liability (by being subject to SECA tax). In this context, therefore, taxpayers will have every incentive to “fail” the definition of material participation. We do not believe that taxpayers should be able to avoid becoming “material participants” simply by forming a series of related entities and dividing their services among them. For these

[37] Treas. Reg. §1.280G-1, Q&A 28.

reasons, while we generally recommend an approach that is largely guided by the standards for material participation under Section 469, we believe that the modifications recommended above will discourage form-driven tax planning and produce a result more consistent with what we understand to be the intended application of Section 1402.[38]

There are other provisions in the Code, notably Section 736, where the statutory language calls for a distinction to be made between "general" and "non-general" partners. Indeed the analysis for Section 736 purposes is somewhat analogous to that required for Section 1402(a)(13), as the question there is whether a payment to a retiring partner represents a form of disguised compensation for services. In relation to Section 736, some commentators have suggested a "materiality" threshold in evaluating the degree and nature of a partner's contributions to the partnership.[39] While a similar recommendation could apply for Section 1402(a)(13), we believe a test that draws on the Section 469 material participation rules makes the most sense in the context of the self-employment tax for a number of reasons. First, as discussed in the 2010 NYSBA Report, there will be significant advantages to using the Section 469 material participation test for determining whether a partner's distributive share should be subject to SECA taxes, since the Treasury Department and the Service have already dedicated substantial resources to crafting a test that distinguishes between passive investors and active participants and have experience in applying this test. Second, the test is more objective and

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[38] The IRS has recently argued that members of a LLC and limited partners of a LLP are "limited partners" for Section 469 purposes. (*See* Paul D. Garnett, et ux. v. Com'r, 132 TC 368 (2009); Thompson v. U.S., 87 Fed. Cl. 728 (2009). ("[IRS] contends that petitioners obtained a tax benefit by failing to designate their interests as "general partner" interests, in that they thereby avoided self-employment tax pursuant to section 1402(a)(13), which excludes from self-employment earnings certain distributive shares of a "limited partner." Garnett, at 382-83). No such inconsistent treatment would exist if the regulations were to require the general partner test under Section 469 to be applicable for Section 1402 purposes.

[39] *See* "L.A. Bar Members Suggest Ways to Classify LLC Owners as Partners," 96 TNT 96-32 (May 3, 1996). *See also* Frost, "Square Peg, Meet Round Hole II: We Still Don't Know Whether to Classify LLC Members as General Partners or Limited Partners for Federal Tax Purposes," 75 TAXES 676 (Dec. 1995).

precise and therefore easier to administer. Finally, adopting a material participation test that follows the relevant approach under Section 469 would generally require taxpayers to take consistent tax positions with respect to Section 1402, the passive loss rules of Section 469, and the new Section 1411 Tax.[40]

B. Service Partnerships.

Previous proposals to clarify the application of the SECA tax to pass-through entities, including the 1997 Proposed Regulations, had included special rules for partnerships whose principal activity consisted of performing services (a "service partnership" or "SP"). We recommend that any future guidance take a similar approach, and we support the rule contained in the 1997 Proposed Regulations under which any partner who provides more than *a de minimis* amount of services to or on behalf of a SP's trade or business cannot qualify as a limited partner. The term "service partnership" was defined, in the 1997 Proposed Regulations, as a partnership "substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[41] We essentially support this approach to defining a SP, though we recommend expanding the list of service fields included in the definition, as we describe below.

First, we believe the reference to "substantially all" in the definition of "service partnership" as it appeared in the Proposed Regulations unnecessarily confuses matters and is likely to give rise to inappropriate tax planning and disputes. Clearly an entity can be engaged in multiple businesses, and drawing lines between whether *substantially all* of its activities fall

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[40] Our recommendations in this Report are limited to the rules that should apply in the context of Section 1402, and a review of the relevant tests for purposes of Section 736 or other Code provisions where distinctions are made between "general partners" and non-general partners is beyond the scope of this Report.

[41] Prop. Treas. Reg. §1.1402(a)-2(h)(5).

within a specific category of business activity, or less than substantially all, seems unnecessary. The relevant feature is that the partnership is providing services and that therefore a partner providing those services is engaging in *work*. For SECA purposes it should not matter how the amount of those services compares to the remainder of the partnership's activities. We recommend that any income resulting from, or attributable to, the service-providing activities of a service partnership (i.e., from the service business itself), cannot be treated as being earned by a limited partner for purposes of Section 1402 (where the relevant partner provides more than a de minimis amount of service to the partnership).

There are other provisions in the Code where "substantially all" is referenced in relation to a determination that is tied in some manner to the provision of services, but in these cases the reference test is relevant to a tax or allowance of some kind that applies to the entity as a whole. For example, under Section 448 a "qualified personal service corporation" is allowed to use the cash method of accounting if it meets a function test and an ownership test. The function test is tied to whether "substantially all" of the services of the entity fall into certain specified fields. The applicable Regulations address the meaning of "substantial services," providing that the test is satisfied only where 95% or more of the "time spent" by employees every year (in their capacity as such) is devoted to performing services in the relevant field.[42] Another example can be found in Section 41 of the Code, which provides for a research tax credit and defines "qualified research" by reference to the nature of certain activities carried on. Section 41(d) refers to whether "substantially all" of the activities constitute a process of experimentation. Applicable regulations provide that the "substantially all" requirement is met only if 80% or

[42] Treas. Reg. §1.448-1T(3)(4).

more of a taxpayer's activities, measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation.[43]

We believe that the SECA tax calls for a different approach than we see in these other contexts. In these other contexts, where the entity's overall eligibility for a specific rule is being determined, the proportion of services to other activities may be relevant. In the SECA context, the only relevant inquiry is whether the partner is providing services that would, if conducted directly by the partner, constitute "self-employment." Section 1402 references "a" trade or business and Section 1402(a)(13) refers to items of income or loss "of a limited partner." There is nothing in the current framework of Section 1402 that mandates an all-or-nothing test, or an all-or-nothing result (i.e., that *all* of a service provider's allocable share of income would be treated as NESE). Instead, Section 1402 permits (and in fact calls for) a rule that only the income attributable to the service business to be treated as NESE.[44] For these reasons, we recommend that the term SP should be defined as "any partnership whose activities include any trade or business involving the performance of services" in the specified fields.

We also believe that some consideration should be given to expanding the list of service fields, so as to include other non-capital intensive service businesses, such as providing investment advice or management, computer programming, design services, or other services that are not capital intensive. Previous proposals have included a definition of service business that listed specific fields, but adding a reference to "any other trade or business with respect to which the Secretary determines that capital is an insignificant income-producing factor."[45] We

[43] Treas. Reg. §1.41-4(a)(6).

[44] Indeed, a tracing approach already exists since items of passive income that are allocated to a partner would be excluded from SECA tax by virtue of the provisions of Section 1402(a)(2) or (a)(3), for example.

[45] *See* Health Security Act, S. 2351, 103d Cong., 2d Sess. Section 716 (1994).

do not see any logical basis for leaving other non-capital intensive businesses, or the wide range of personal service businesses that are not within the limited specified fields referred to in the 1997 Proposed Regulations, entirely out of this regime. We recommend that an expanded list be included in the regulations, along with authorization for the Secretary to expand the list to include other non-capital-intensive businesses.

While we support the "material participant" test outlined above for partners in non-SPs, in the case of SPs, we believe that any partner who provides more than a de minimis amount of services to the SP be subject to the SECA tax on that service partner's share of the SP's income from providing services. We do not think the material participation test is appropriate here because we believe that any partner that provides services to a SP should be subject to SECA tax on her share of the SP's services income.[46] This mirrors the result that would occur if the individual were engaged in the provision of services directly, as a sole proprietor.

C. Bifurcation Issues for Non-service Partnerships.

If a partner were to be required to pay self employment tax under the provisions we recommend above, (i.e., by meeting the "material participation" test or by providing more than a de minimis amount of services to a service partnership), another issue that could arise relates to the bifurcation of interests in a partnership, where a partner holds different classes of interests (or, in some cases, even where the partner holds a single class of interest received for services). The 1997 Proposed Regulations addressed this issue to some extent.[47] The 1997 Proposed

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[46] In the 1997 NYSBA Report, we stated that "[t]o the extent that the Proposed Regulations' requirement of identical interests relates to a concern that non-limited partners who do not put up capital should not be permitted to rely on the bifurcation rules, we would support an explicit rule to that effect. Specifically, we suggest that a partner who materially participates in the partnership's business, and who receives in exchange for services solely a disproportionate profit share, should not be entitled to rely on the bifurcation exceptions."

[47] Prop. Treas. Reg. §1.1402(a)-2(h)(3).

Regulations included a rule permitting a person who would otherwise be excluded from LP treatment (because he participated in the partnership's trade or business for more than 500 hours a year) to nevertheless treat any interest identical to those of other non-service providing LPs as a LP interest if immediately after the person acquired the interest, other "limited partners" owned a substantial, continuing interest in such class and the rights and obligations with respect to the particular class were identical. As we stated in our 1997 NYSBA Report, "the latter exception was designed to force partnerships to provide for explicit guaranteed payments to participating partners, whose residual interest is thereby relieved from the NESE taint."[48] In our 1997 NYSBA Report on the Proposed Regulations, we stated that we agreed with this approach in concept, noting that it avoided certain difficult factual inquiries that inevitably arise when attempting to draw lines between "arms-length compensation for services" and a right to share in partnership income. However, the 1997 NYSBA Report went on to observe that:

> . . . we think that the benchmark as proposed is too rigid to be of real practical use. First, the requirement that other partners, not excluded from limited partner status under the general rules of paragraph (h)(2), own a "substantial" interest, and the suggestion that "substantial" means 20% or more, strikes us as an overly-high threshold. If the concern is that interests may be given to passive accommodation parties in order to achieve bifurcation, we think that a 10% interest would be significant enough to avoid such a practice.[49]

Our recommendations and thoughts on the subject of bifurcation, particularly in relation to partners in service partnerships and to partners who materially participate in the activities of the partnership, have shifted since 1997; this is largely a result of the passage of Section 1411.

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[48] 1997 NYSBA Report, at para. 32.

[49] 1997 NYSBA Report, at paras. 33-34. The 1997 NYSBA report's analysis of the special bifurcation provisions noted some additional comments on the benchmark test contained in the regulations, namely that (i) the "immediately after requirement" should be modified to require only that the limited partners own their interests (on other than a transitory basis) at some time during the same taxable year; (iii) "continuing" should mean "other than transitory"; and (iv) the "are identical" requirement should be replaced with a comparative "to the extent similar" rule that focuses on the economics of the interests involved. *Id.* 34-37.

We observe that certain anomalous results may occur if “material participants” are allowed to bifurcate their interests, resulting in allocations of active income that are exempt from SECA tax yet possibly not subject to tax under Section 1411 even though the same income would be subject to full taxation under Section 1411 to a passive individual partner of the partnership.[50] We also note that the SECA tax would not apply to the partner’s shares of the partnership’s passive income, due to the exceptions contained in Sections 1402(a)(2) and (a)(3). Thus, if the partnership is generating passive income in addition to trade or business income, such income is already exempt from SECA tax in the hands of a partner who is a material participant or a SP.

If the provisions of the 1997 Proposed Regulations are adopted, it may be possible for taxpayers to structure an interest that is received for services to mirror an interest of an outside, passive, investor in the partnership. Our 2008 NYSBA report on proposals to modify the tax treatment of the Carried Interest[51] reflected the enormous complexity involved in segregating an interest received “for capital” from an interest received “for services.” In theory, while we have supported the premise that SECA tax should not apply to the portion of any allocable share of income representing a return on capital invested or a return of “enterprise value,” we question whether a “material participant” should be permitted to carve out (or bifurcate) an interest, treating it as a “LP” interest for Section 1402 purposes. Given the range of complex issues such a bifurcation approach presents, we recommend that a partner of a partnership who provides

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[50] To illustrate this point, assume X is a material participant in a restaurant business. Due to his material participation, any allocable share of the earnings from the restaurant business would appear not to be captured by Section 1411. If Section 1402 allows X to “bifurcate” some portion of his interest (the portion that is identical to that of outside investors), X would not be subject to tax under Section 1401 for that portion (while the outside investors, assuming they meet the relevant income threshold under Section 1411, would be taxed on their income allocations at a 3.8% rate under Section 1411). This example may indicate that there should be no bifurcation allowed under Section 1402 for anyone who is a “material participant” in the partnership, in order to rationalize the results for both passive and active members or partners.

[51] *See* NYSBA Report No. 1166 “Report on Proposed Carried Interest and Fee Deferral Legislation,” pp. 19-30, Sept. 24, 2008.

more than a de minimis amount of services should not be allowed to bifurcate the partner's interest in the partnership, regardless of whether she holds different classes of interests in the partnership, some of which are arguably identical to those of a non-service provider (for service partnerships by their nature are not capital intensive). We think consideration should also be given to whether a material participant should be allowed to bifurcate an interest, treating it as a LP interest for SECA tax purposes.

D. Interaction Between Section 1402(a)(10) and the Section 1402(a)(13) Exclusion.

Section 1402(a)(10) provides an exception to the SECA tax for certain payments to retired partners. Section 1402(a)(10) requires that the retired partner provide no services with respect to any trade or business of the partnership in the taxable year in which the retirement payment is received. Both the retired partner exclusion and our recommended *material participant* standard, for purposes of Section 1402(a)(13), look to the amount of services provided by a partner in determining the applicability of the SECA tax. Section 1402(a)(10) should continue to have relevance if our proposals are adopted. Thus, any regulations would have to provide that when dealing with a retired partner, the provisions of the "material participation test" that look to services in past years (i.e., prongs 5 and 6 of the test) would not be relevant, or, alternatively, that even if they are applied, that the provisions of Section 1402(a)(10) would override subsection (a)(13), regardless of the level of the retired partner's past participation in the entity's activities.

E. Application of Material Participation Rule in the Context of Tiered Flow-Through Entities.

As discussed in our 2010 NYSBA Report, a specific provision addressing tiered entities needs to be incorporated into any guidance adopted, in order to account for the participation by an owner of an interest in an “upper-tier entity” in the business or activity of a lower-tier entity. Assuming that our recommendation above for a “material participation” standard were to be adopted in final regulations, we believe that any person who materially participates in the activity or business of a partnership must be required to treat income that flows up from that partnership through any other intermediate entity as being subject to SECA tax, regardless of whether or not the person materially participates in the activity of the intermediary entity. The applicable provisions should require that a distributive share of income “attributable to” a partnership in which a person materially participates will be subject to SECA, thus providing for some tracing concept. The same rule should apply in the case of a partner who would be a service partner were she to be a partner directly in the lower-tier partnership.

We note that the tracing principles we are recommending would not resolve the SECA tax treatment when one of the entities in the tiered structure is an S corporation. For example, a lower tier partnership might issue an interest to an S corporation, and a shareholder of the S corporation might “materially participate” in the business of the lower tier partnership and receive his distributive share indirectly, as a dividend distribution by the S corporation. Given the current statutory framework, regulatory guidance under Section 1402 may not be sufficient to address tiered ownership structures involving S corporations. The reason is that the SECA statute currently provides that a shareholder of an S corporation is not subject to SECA tax on dividends (and this is the case even if the source of the dividends is the S corporation’s distributive share of partnership income). As we noted above, S corporations raise issues that are beyond the scope of this report, although we refer to the proposed S corporation legislation discussed in our 2010 NYSBA Report.[52]

3. Guidance Clarifying the Intended Application of Section 1411 to "Investment Partnerships" and the Section 1402 / Section 1411 Interplay.

Thus far, the discussion in this Report has focused on the definition of "limited partner" for SECA tax purposes. We have recommended that active, "material participants" in the partnership's activities should not be treated as "limited partners" for purposes of the exclusion from SECA tax under Section 1402(a)(13). Even if such an individual does not qualify as a limited partner, however, she may earn other types of income not subject to tax under Section 1401. Specifically, Section 1402 (a)(3) excludes all amounts treated as gain or loss from the sale or exchange of a capital asset and Section 1402(a)(2) excludes certain dividend and interest income—the idea being that income of this character is of a more "passive" nature and not attributable to the performance of services.

Most (but not all) investment income excluded from SECA will be subject to the Section 1411 Tax beginning in 2013. The statutory language of Section 1411 reflects Congress' intent to tax income not already taxed by SECA, in particular certain types of passive income from investments, including (i) dividends, interest, and capital gain, (ii) income from any business that is a "passive activity" with respect to the taxpayer, and (iii) income from "trading" in financial instruments or commodities.

While Section 1411 imposes the same rate of tax on investment income as SECA imposes on service income, Section 1411 differs from Section 1402 in certain respects. First, Section 1411 only applies to individual taxpayers whose modified adjusted gross income exceeds

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[52] We expressed strong support in the past for legislation that would rationalize the tax treatment of all flow-through entities, including S corporations. *See* the 2010 NYSBA Report.

a threshold amount of $200,000 ($250,000 in the case of taxpayers who jointly file returns)).[53] Second, the 3.8 percent tax (none of which is deductible)[54] applies only to the "net investment income" of such taxpayers, not all investment income.[55]

"Net investment income" is defined in Section 1411(c)(1)(A) as the sum of:

- Gross income from interest, dividends, rents and royalties, *other than* such income which is derived in the ordinary course of a trade or business not described in paragraph (c)(2) (Section 1411(c)(1)(A)(i));

- Other gross income *derived from* a trade or business that is a passive activity with respect to the taxpayer (within the meaning of Section 469), or that involves the trade or business of trading in "financial instruments and commodities" (as defined in Section 475(e)(2)) (Section 1411(c)(1)(A)(ii);

- Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property *other than* property held in a trade or business that is not covered in paragraph (c)(2) (Section 1411(c)(1)(A)(iii).

A trade or business is described in Section 1411(c)(2) if such trade or business is:

(A) a passive activity with respect to the taxpayer (within the meaning of Section 469);

or

(B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).[56]

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[53] Section 1411(a)(1).

[54] Unlike Section 1402, which provides for a limited deduction for SECA taxes, taxpayers will not be able to claim a deduction for taxes imposed by Section 1411.

[55] For example, capital gain realized by a partnership on assets held in its trade or business (i.e., a building held in a restaurant business) and allocable to an individual partner who materially participates in the trade or business of the partnership is exempt from tax under Section 1411.

[56] Section 1411(c)(2).

Our comments in this part of our Report relate solely to the application of Section 1411 to income attributable to the carried interest of a typical investment partnership (whether such individual holds the carried interest directly or through one or more intermediate partnerships). By "investment partnership," we mean a typical private equity, venture capital, LBO, real estate or hedge fund. For this purpose, we believe that Section 412 of the American Jobs Act,[57] which is the latest iteration of several legislative proposals to tax the carried interest as service income for all federal income tax purposes (including SECA), provides a useful working definition of an investment partnership. Under the Act, a partnership is an investment partnership if, subject to certain exceptions, substantially all of its assets consist of "specified assets," including stock, debt, most categories of real estate and certain other types of investment assets.

For tax purposes, most investment partnerships fall into one of two categories: those that do not engage in any trade or business and those that engage in a "trading" trade or business. A typical private equity, LBO or venture capital fund ("Private Equity Fund") falls into the first category because it invests in stock of privately-held corporate portfolio companies.[58] A typical hedge fund ("Hedge Fund") invests in marketable securities, generally buying and selling with a certain degree of frequency, and therefore falls into the second category, provided that its investment activities qualify as "trading" in stocks and securities.[59]

Investment partnerships often grant a "carried interest" to the managing member/general partner (the "Manager") as partial consideration for managing their investments. Because a

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[57] American Jobs Act of 2011, S. 1549, Sec. 412 (2011).

[58] Investing in stock or securities on a long term basis, in order to realize capital gains, dividend or interest income is not generally considered to constitute a trade or business. See Higgins v. Commissioner, 312 U.S. 212 (1941); Purvis v. Commissioner, 530 F. 2d 1332 (9th Cir. 1976); Chiang Hsiao Lang, 23 T.C. 1040 (1955).

[59] If a particular Hedge Fund does not buy and sell marketable securities will sufficient frequency to qualify as a "trader," it will fall into the first category of funds.

carried interest qualifies as a partnership interest for tax purposes, any income allocable to the Manager will retain its character at the partnership level and will therefore be subject to tax to the Manager or its individual owners as capital gain or other investment income. As such, the income is exempt from SECA tax under Sections 1402(a)(3) or 1402(a)(2). As additional consideration for managing its investments, most investment partnerships also pay a periodic management fee to the Manager or an affiliate of the Manager, determined by reference to committed and/or invested capital.

As described more fully below, we believe that Section 1411 applies to the carried interest whether the investment partnership is a Private Equity Fund that "invests" in stocks or securities for its own account or a Hedge Fund that "trades" in stocks or securities for its own account. We do not believe that an individual's "material participation" in any trade or business of the Manager or any other affiliate that owns a direct or indirect interest in the carried interest is relevant to this determination.[60]

A. Investment Partnerships Not Engaged in a Trade or Business.

In a typical Private Equity Fund, substantially all of the income allocable to the carried interest consists of capital gain from the sale of portfolio company investments by the fund. Section 1411(c)(1)(A)(iii) defines "net investment income" to include gain attributable to the "disposition of property" unless the seller of the property held the property in a qualifying trade or business. Because the seller of the property is the Private Equity Fund, the only trade or business of any relevance to Section 1411 is the trade or business of the Private Equity Fund, not the trade or business of the Manager or its members. As mere "investors," these funds do not

[60] These comments on Section 1411 supplement the comments reflected in our Letter dated September 29, 2010, addressing certain ambiguities that we thought should be addressed under Section 1411. This Report comments more specifically on the interaction of Section 1411 and Section 1402.

engage in *any* trade or business. Accordingly, Section 1411 should tax all gain realized by the fund and allocated to the carried interest, regardless of whether the Manager or any affiliate is engaged in a separate trade or business.

The rest of the income will generally consist of dividends (or interest) from the same portfolio companies of the fund. Section 1411(c)(1)(A)(i) taxes dividends and interest except to the extent "derived in" a trade or business in which the individual materially participates. It is here that the literal language of the statute is arguably ambiguous as applied to the carried interest. As described more fully below, Section 1411 could be construed to exclude such income on the basis that it is "derived" from the Manager's investment management trade or business, not the underlying fund. Under this interpretation, however, the statute could potentially tax the Manager on its allocable share of the capital gain but exempt the Manager on its allocable share of any intervening dividends. We do not believe that Congress could have intended to discriminate between dividends and capital gain on the same equity investment because there would be no apparent policy rationale for doing so. Accordingly, Congress must have intended to tax these dividends on the basis that they are "derived from" the carried interest in the Private Equity Fund, not from any separate trade or business activities of the Manager (if any).

B. Investment Partnerships Engaged in a Trade or Business.

Unlike Private Equity Funds, Hedge Funds hold marketable securities. When they sell these securities, they generally reinvest (rather than distribute) the proceeds in other marketable securities. Hedge Funds therefore tend to buy and sell with much greater frequency than Private Equity Funds. In many cases, the rate of turnover is sufficient to establish a "trading" trade or business. Section 1411 also taxes income from the trade or business of trading in "financial instruments" (as well as commodities).[61] So long as the portfolio of such a Hedge Fund consists of "financial instruments" and/or commodities, therefore, Section 1411 will tax the carried interest in these investment partnerships as well.

Section 1411 does not define the term "financial instruments." The same term appears in several other provisions of the Code, including Section 731, Section 954, and Section 6038D. Notably, Section 6038D draws a distinction between stock or security and financial instrument. For purposes of Section 1411, we believe Treasury should issue guidance to clarify that the term "financial instrument" includes stock, securities, derivatives and other similar instruments of the type typically held by a Hedge Fund.[62]

C. Relevance of Trade or Business of UTPs.

In virtually every fund, the Manager is not an individual, but an upper-tier entity taxable as a partnership ("UTP"). The individual service providers participate in the underlying carried interest in their capacity as partners of the UTP. In some funds, a single UTP both holds the carried interest and manages the investments of the fund through these individuals (a "Single UTP Structure"). In other funds, separate UTPs hold the carried interest in the fund and manage the investments of the fund (a "Split UTP Structure"). In these Split-UTP Structures, the owner of the carried interest is just a holding company that engages in no business activity at all.

The individual members in any fund with a Split-UTP Structure will be subject to tax under Section 1411 on their entire allocable share of the investment income of the fund because the UTP owner of the carried interest will not be engaged in any trade or business (passive or

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[61] Section 1411(c)(1)(A)(ii).

[62] Some hedge funds "originate" loans. Whether the interest on the loans may be exempt from tax under Section 1411 as attributable to "loan origination activities" is not entirely clear. It would be helpful if future guidance addressed whether Section 1411 applies to interest on originated loans.

otherwise). In a fund with a Single-UTP Structure, the same individuals may assert that they "materially participate" in the investment management trade or business of the UTP Manager. In such a case, they may further contend that the references to "trade or business not described" or "trade or business not covered" in paragraph (c)(2) refer to the trade or business of the UTP and that Section 1411 therefore excludes all or a portion of their investment income attributable to the carried interest.

We do not believe this is a proper reading of the statute. First, funds that adopt Split-UTP Structures usually do so to reduce state and local taxes on the carried interest, not to establish any overriding business objective. For this reason, the separate UTPs usually have substantial overlapping owners. Second, it would make no sense for the statute to favor individuals employed by funds with Single UTP Structures where the grantee of the carried interest actually provides the bargained for services over individuals employed by funds with Split UTP Structures. In fact, we believe the statute was drafted in order to avoid this interpretation, since Section 1411 specifically makes use of the phrases "derived from" and "attributable to" in its text. We believe this usage was purposeful, and that the use of these phrases implies the necessity of a tracing approach.

In the case of a Private Equity Fund, therefore, because the investment partnership is not engaged in a trade or business, any income from the carried interest should not qualify as attributable to any trade or business and should therefore be subject to tax under either Section 1411(c)(1)(A)(i) (e.g., dividends or interest) or (c)(1)A)(iii) (capital gain)—regardless of whether the Manager merely holds the carried interest as a passive holding company or actually provides the investment management services. The same logic would extend to the Hedge Fund scenario.

Although the Tax Court recently addressed the trade or business determination in the fund context in Dagres v. Commissioner,[63] we do not believe that Dagres has any bearing on the application of Section 1411 to the carried interest. In Dagres, the taxpayer was an owner of various general partners of venture capital funds. Each general partner managed the investments of the funds, for which it received a carried interest and a periodic management fee. After a loan by the taxpayer became worthless, the taxpayer claimed an ordinary bad debt loss under Section 166. The Tax Court allowed the ordinary loss, finding that the loan arose in connection with the taxpayer's (and general partner's) trade or business of providing investment management services to the underlying funds.[64]

The reason that Dagres is drawing attention among tax advisors to investment partnerships is that the general partner in Dagres had subcontracted its entire service obligation to an affiliate, which received the entire management fee directly from the relevant funds. As such, the general partner in Dagres operated in a manner similar to the general partner of a fund in a Split-UTP Structure. The finding of the Tax Court, that the general partner was nevertheless engaged in a trade or business, may therefore call into question whether a tax-exempt or foreign member of such an entity is required to treat its allocable share of the capital gain as "unrelated business taxable income" under Section 512 or "effectively-connected income" under Section 882, respectively. Regardless of whether this concern is legitimate, Dagres is not relevant to the

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[63] 136 T.C. 12 (2011).

[64] Section 166 allows an individual to take an ordinary income deduction for a loan (held by the individual) that is not a security and that becomes worthless within the taxable year, provided that the loan is created in connection with a trade or business of the individual. The Tax Court stated that "Mr. Dagres's dominant motivation for lending [the money] to the obligor was to gain preferential access to companies and deals to which [the obligor] might refer [Mr. Dagres], so that Mr. Dagres could use that information in the venture capital activities," *id.* at 163, which, arguably, would indirectly increase the income to Mr. Dagres from management fee payments from the venture capital funds to its general partners.

question of whether Section 1411 applies to the carried interest because it addresses the trade or business (if any) of the wrong entity.

As described above, the *only* trade or business of any relevance to Section 1411 in the fund context is the trade or business of the *issuer* of the carried interest, not its owner, whether such owner is an individual, a UTP or an S corporation. Nevertheless, we believe that it would be helpful, in the interest of aiding the administration of this new statutory provision, if Treasury were to confirm this interpretation by issuing some future guidance

Finally, if specific guidance were to be issued regarding the scope of Section 1411, such guidance could articulate what principles apply in other tiered structures. For example, an ownership interest in a partnership could be dropped into an upper tier entity characterized as an S corporation. The Manager of an investment partnership could hold a carried interest through a vehicle taxed as an S corporation, and that S corporation could earn management fee income in exchange for services. We believe the statutory language of Section 1411 would allow for a tracing approach even with the use of intermediary entities such as S corporations. Specifically, Section 1411(c)(4) looks through to the "inside assets" of certain entities for purposes of one of the prongs of the definition of "net investment income." This reflects, in our view, an extension of the principle that the concept of "net investment income" was designed to look to the source of specific income, as evidenced by the use of the words "derived by" or "derived from" in the statute. Application of these provisions should not be easily evaded through the use of an S corporation, and guidance could provide that where an S corporation shareholder materially participates in the business of an S corporation or a lower tier partnership, any dividends earned by the S corporation and/or its shareholders that are attributable to an investment in a lower tier flow-through entity will similarly be treated as being *derived from* the relevant underlying asset and subject to tax under Section 1411.

4. Authority to Issue Regulations Under Section 1402.

Finally, we would like to address the question of the Treasury Department's authority to issue regulations defining the term "limited partner" for purposes of Section 1402(a)(13). While we believe that Treasury clearly has the necessary authority, we recognize that there may be some lingering uncertainty in light of the 1997 Moratorium. We address that here.

Thirteen years have passed since the 1997 Moratorium expired; the Moratorium provided a 12-month "no final action" period, and it then expired. Since it expired, Congress has not renewed it, nor has Congress amended Section 1402(a)(13). Rather, Congress remained silent until 2010, when Congress enacted new Section 1411. Section 1411 reflects a Congressional view that income that is exempt from the Section 1401 tax because it is not sufficiently linked to a trade or business to be "earned income" (i.e., is passive income), should instead be subject to a mirror tax imposed at the same rate, if earned by certain individuals. This approach implies an understanding that all *earned income* was already subject to the Section 1401 SECA tax (or the FICA tax).

Section 1402(a)(13) was enacted to prevent individuals from treating "passive income" as if it were "earned income."[65] The 1997 Proposed Regulations represented Treasury's attempt to carry out Congress's initial goal. The 1997 Proposed Regulations were, however, criticized as contradicting the statute (for example, by (i) departing from an approach based simply on traditional State law classifications and (ii) subjecting to SECA tax income that is in substance a

[65] *See* H.R. REP. NO. 95-702(I), pp. 40-41 (1977) (addressing P.L. 95-21, Social Security Amendments of 1977). *See also* William L. Raby & Burgess J.W. Raby, "Self-Employment Income of LLC 'Partners'," 2003 TNT 108-49 (June 5, 2003).

return on invested capital). The criticisms motivated Congress to issue the Moratorium that would slow down the process and give everyone (including Congress) time to consider these issues.[66]

Fourteen years have passed and Congress has not spoken again regarding Section 1402(a)(13). During that decade and a half, LLC and LLPs have proliferated, and state partnership and limited liability company laws have become even more flexible—all developments that facilitate earned income being derived through partnership interests that are not "general partner" interests. In addition, the newly-enacted Section 1411 intentionally imposes a 3.8% Medicare tax on income that represents a "return on invested capital."

For all of these reasons, we do not believe the Moratorium (or the concerns that prompted the Moratorium) have relevance today in evaluating the scope of the Treasury Department's authority to issue interpretive regulations under Section 1402(a)(13).

Furthermore, and most importantly, the Supreme Court's decision earlier this year in Mayo Foundation for Medical Education v. US[67] provides clear support for the Treasury

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[66] It has been suggested that Congress passed the moratorium in 1997 in part because of a failure to provide notice and follow certain other procedures required by the Regulatory Flexibility Act (5 U.S.C. 601-12), which had been expanded in 1996 to include Treasury regulations, Sec. 241, Small Business Regulatory Enforcement Fairness Act of 1996, P.L. 104-121. *See* Stuart Levine & Marshall Paul, *IRS Shifts Focus With Controversial New SE Tax Proposed Regulations*, 86 J. TAX'N 325, 330 (1997). (The Regulatory Flexibility Act requires administrative agencies to evaluate the impact of rulemaking on small entities. When a proposed rule imposes a significant economic impact on a substantial number of small entities, the administrative agency must analyze alternatives that would achieve the purpose of the rule without unnecessarily burdening small entities. Pursuant to the statute, the administrative agency makes its initial analysis available for public comment, after which it publishes the final analysis in the Federal Register with the final rule.) Such failure in 1997 would not be relevant to regulations proposed now, providing the proper notice and comment procedures are followed.

Department's authority to issue regulations along the lines discussed above. In Mayo, the Supreme Court held that the two-step standard established in Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.[68] is to be applied when determining the validity of interpretive regulations issued by the Treasury Department.[69] The issue in Mayo was the validity of the definition of the term "student" as set forth in Treasury regulations pertaining to FICA taxes. The Court began its analysis with the first step of the two-part test established in Chevron, asking if the precise question at issue had been addressed by Congress, concluding that Congress had not addressed the meaning of the term "student." Similarly, in the case of Section 1402(a)(13), Congress has not addressed the meaning of the term "limited partner," despite the fact that this definition is crucial for purposes of applying the provisions of Section 1402 and the tax imposed by Section 1401. The Court in Mayo then applied the second step of the Chevron test: whether the rule is a "reasonable interpretation of the enacted text."[70] An agency rule may not be

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[67] 131 S.Ct. 704 (2011). In addition to Mayo Foundation for Medical Education v. United States, *infra*, other courts have upheld interpretive tax regulations in litigation challenging their validity in recent years. For example, in McNamee v. Dept. of the Treasury, 488 F.3d 100 (2nd Cir. 2007), the Second Circuit in 2007 upheld the validity of the check the box regulations, where the taxpayer challenged their application to a single member LLC (thereby imposing liability on him for unpaid payroll taxes of the accounting firm). The Sixth Circuit, in Litriello v. United States, 484 F.3d 372 (6th Cir. 2007), reached a similar conclusion, stating "It is unnecessary, in our judgment, to engage in an exegesis of Chevron here. The perimeters of that opinion and its directive to courts to give deference to an agency's interpretation of statutes that the agency is entrusted to administer and to the rules that govern implementation, as long as they are reasonable, is clear, and are clearly applicable in this case." Litriello, at 377. Indeed, the Court in Litriello went on to also address the question of state law classification, which the taxpayer raised as an obstacle to the government's regulations, but the Court did not accept this argument: "The federal government has historically disregarded state classifications on businesses for some federal tax purposes." Litriello, at 379.

[68] 104 S. Ct. 2778 (1984).

[69] The Court decided whether to apply the less deferential standard from National Muffler Dealers Assn., Inc. v. United States, 99 S. Ct. 1304 (1979) or to apply the more deferential standard of Chevron. Specifically, the Court stated, "Aside from our past citation of National Muffler, Mayo has not advanced any justification for applying a less deferential standard of review to Treasury Department regulations than we apply to the rules of any other agency. In the absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only…. The principles underlying our decision in Chevron apply with full force in the tax context." Mayo, at 713.

[70] Mayo, at 714.

invalidated unless it is “arbitrary or capricious in substance, or manifestly contrary to the statute.”[71] There, the Court found that the Treasury’s definition of “student,” which excluded individuals working more than 40 hours per week, easily satisfied the second step because Treasury “reasonably sought a way to distinguish between workers who study and workers who work” and “focusing on the hours an individual works and the hours he spends in studies is a perfectly sensible way of accomplishing that goal.”[72] With respect to the regulatory guidance recommended in this Report, Treasury would be acting to rationalize and clarify the scope of the rules applicable to partners of pass-through entities for self-employment tax purposes—and to insure that the imposition of the self-employment tax does not turn upon the formalistic categorization of an entity as either a “limited partnership,” “limited liability company,” or “limited liability partnership,” but rather on whether the distributive share of partnership income is attributable to services performed by the partner. Regulations which seek to distinguish between a passive income stream and an income stream earned in exchange for the performance of services are clearly consistent with the underlying purpose of the statutory provisions. We view this as a reasonable and necessary objective.

Thus, we believe that interpretive guidance issued by the Treasury defining the meaning of “limited partner,” along the lines of the guidance contained in the 1997 Proposed Regulations, should easily meet the Mayo standard so long as the notice and comment procedures mandated by the Administrative Procedures Act[73] are met; under the Mayo standard, such guidance would be neither arbitrary nor capricious. Furthermore, we believe that any modifications to the 1997

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[71] Mayo, at 711, citing Household Credit Services, Inc. v. Pfennig, 541 U.S. 232, 242 (2004).

[72] Mayo, at 715.

[73] P.L. 79-404.

Proposed Regulations along the lines we recommend in this Report would easily meet the Chevron standard adopted in Mayo. In each case, the rules adopted would not be manifestly contrary to the statute because the spirit of the rule is already expressed in Section 1402(a)(10). In Section 1402(a)(10), periodic payments made to retired partners are effectively excluded from federal employment taxes if, among other things, the recipient "partner rendered no services with respect to any trade or business carried on by such partnership (or its successors) during the taxable year . . . in which such amounts were received. . . ." A rule that subjects partnership distributions to self-employment tax where the partner provides services with respect to the partnership's business is not manifestly contrary to an existing statute that subjects partnership distributions to self-employment tax where the retired partner provides services with respect to the partnership's trade or business. Based on this application of the Chevron standard, we believe that Treasury has the authority to issue regulations defining the scope of "limited partner," as described below.

Furthermore, the fact that the 1997 Proposed Regulations were not previously finalized, or that there may have been arguable inconsistencies in positions articulated over the years, should not serve as a basis for challenging any regulations ultimately adopted. In this regard, we wish to draw attention to the Court's statement in Mayo that "[u]nder National Muffler . . . a court might view an agency's interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved. . . . Under Chevron, in contrast, deference to an agency's interpretation of an ambiguous statute does not turn on such considerations. We have repeatedly held that '[a]gency inconsistency is not a basis for declining to analyze the agency's interpretations under the Chevron framework. . . . And, we have found it immaterial to our analysis that a 'regulation was prompted by litigation. . . .'"[74]

[74] Mayo, at 712.