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Article

The New Deal: Hedge Fund Management Fees Are Subject to Social Security Taxes

By Mark Leeds [1]

It's probably fair to speculate that there were significant numbers of tax aficionados (including the author of this article) among the audience for Ken Burns' recent public television extravaganza on the Roosevelt dynasty. Unfortunately for this segment of the audience, the intersection of tax and FDR was not highlighted, with the passage of the Social Security Act receiving only scant mention. Social security taxes have risen dramatically since the enactment of the law. As a result, these taxes have a more prominent role in tax planning than Mr. Burns gave them in his not-so-mini-series. A recent Internal Revenue Service ("IRS") audit ruling highlights planning traps that can dramatically affect when Social Security taxes can be imposed.

On September 5, 2014, the IRS released Chief Counsel Advice 201436049. This CCA addresses an all-too-common structure employed by hedge fund managers to hold the management fee interest in the fund. The structure employed by the funds in CCA 201436049 resulted in the IRS arguing that the full management fee should be subject to Social Security taxes. An alternate structure would have lessened the likelihood of this assertion. This article describes the facts presented by the CCA and the assertion made by the IRS. It also examines an alternate structure and how the use of the alternate structure could mitigate the possible imposition of self-employment tax imposed by Section 1402(a) of the Internal Revenue Code of 1986, as amended (the "Code") and the Medicare Tax imposed on net investment income ("NII") by Code § 1411.

Background

The facts described in CCA 201436049 should sound familiar to any tax person who has spent time structuring hedge funds. At the bottom of the structure was a limited partnership (the "Master Fund").[2] Third party investors purchased limited partnership interests in the Master Fund.

The Master Fund had two general partners: (1) Management Company and (2) Profits GP.[3] The Management Company was organized as a limited liability company (an "LLC") taxable as a partnership. The Management Company had the "full authority and responsibility to manage and control the affairs and business" of Master Fund. This included all investment activities, such as the purchasing, managing, restructuring, and selling of the Master Fund's investment assets. Employees and members of the Management Company conducted these operations. The Master Fund paid a management fee to the Management Company in exchange for these services. The management fee constituted all of the Management Company's gross receipts in the years under IRS audit.

CCA 201436049 recites that all of the members (partners) in the Management Company were individuals. Certain members paid significant sums for their Management Company equity units. Although redacted, it appears that each of such members spent more than 500 hours per year on the business of the Management Company which, as stated above, was conducting investment activities for the Master Fund. The Management Company paid wages to its members[4] and employees, but the facts of the CCA show that the payment of wages did not zero out the income of the Management Company. Accordingly, the Management Company had residual income that it allocated to its members. This income was allocated *pro rata* by the number of Management Company equity units held by each of its members.

The Management Company did not withhold Social Security taxes on the distributive share of the Management Company net income that was allocated to its members. This failure by the Management Company to withhold Social Security taxes was the subject of CCA 201436049. The IRS asserted that the Management Company should have withheld these taxes.

Code § 1402 and Net Earnings from Self-Employment

Under current law, Federal Insurance Contribution Act ("FICA") taxes are imposed on wages, *i.e.*, income from employment paid by an employer. Under a complementary regime, Self-Employment Contributions Act ("SECA") taxes are imposed on earnings from self- employment. For individuals who receive compensation for services from entities taxable as partnerships in which they hold partnership interests, SECA taxes apply. The IRS has ruled FICA does not apply to a partner's partnership income because a partner cannot be an employee of a partnership of which he is a partner.[5]

SECA has three components:

1. The OASDI tax, imposed at a 12.4% tax on net earnings from self-employment ("NESE") up to $117,000 for 2014 (the "OASDI cap"). The OASDI cap is indexed annually for inflation.
2. The Hospital Insurance ("HI") tax. The HI tax is imposed at a 2.9% rate on NESE. There is no cap on the HI tax and it applies to every dollar of NESE.
3. The HI High Earner Surtax. The HI High Earner Surtax is a .9% tax that applies to NESE in excess of $200,000 ($250,000 for married individuals filing a joint return).
4. Code § 1401(a), (b)(1). NESE is defined in Code § 1402(a) and can include an individual's distributive share of income from any trade or business carried on by a partnership in which he is a partner.

NET EARNINGS FROM SELF-EMPLOYMENT AND LLCS AND LLPS

Code § 1402(a)(13) excludes "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" from the definition of NESE. Congress added Code § 1402(a)(13) in 1977 in order to prevent individuals from grossing-up their NESE by their distributive share of partnership income from partnerships when the allocation of partnership income was not compensation for the performance of services.[6] Thus, Code § 1402(a)(13) carves out a limited partner's distributive share of partnership income from the definition of NESE. The enactment of Code § 1402(a)(13) preceded the rapid growth in popularity of LLCs and other limited liability pass-through entities.[7] As noted in the CCA, the scope of activities of the typical limited partner back then was significantly limited compared to

the modern limited partner of a LLC. Under the Revised Uniform Limited Partnership Act of 1976, if a "limited partner" took part in the control of the partnership's business, such person would lose limited liability protection.

Proposed Regulations

Over time, however, as national incomes approached and then exceeded the Social Security cap described above, the focus of the government changed. The IRS, instead of seeking to prevent individuals from including partnership income in their Social Security tax base, wrote rules that curtailed the ability of limited partners to exclude partnership income from NESE. Specifically, in January 1997, the IRS proposed regulations (the "1997 Proposed Regulations") that generally would have prevented partners (including LLC members) who, among other things, provided more than 500 hours of service to the partnership from being treated as "limited partners" for Code § 1402(a)(13) purposes.[8] However, in August 1997, Congress imposed a one-year moratorium preventing the Treasury from adopting regulations dealing with the employment tax treatment of limited partners (the "1997 Moratorium").[9] The moratorium expired on July 1, 1998. The 1997 Proposed Regulations were never adopted, even after the 1997 Moratorium expired. CCA 201436049 briefly discusses the 1997 Proposed Regulations in passing, but focuses its analysis on legislative history and case law.

Legislative History

The legislative history of Code § 1402(a)(13) demonstrates a shift from subjecting all of partner's distributive share to self-employment tax, regardless of such partner's role and responsibilities in his capacity as a partner, to a recognition that "certain earnings which are basically of an investment nature" should be exempt.[10] However, Congress drew a line: "The exclusion from [Social Security] coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership."[11] In CCA 201436049, the IRS concluded that the intent of the statute was to exempt individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations.

Judicial Authorities

The IRS in CCA 201436049 grounded its assertion that income allocated by the Management Company to its member should be subject to NESE on the decision in *Renkemeyer, Campbell & Weaver, LLP*. [12] The taxpayers at issue in that case were attorney-members of a Kansas LLP engaged in the practice of law. Each LLP member was provided with the same liability protection as a limited partner. The LLP reported business revenues from its law practice on IRS Forms 1065 for the relevant tax years, but no portion of those revenues was included on the law firm's tax returns as NESE. The IRS asserted that the attorney-partners' distributive shares of the law firm's business income for the relevant tax years was subject to self-employment tax. As in the CCA, the *Renkemeyer* court's decision turned on whether the attorney-partners were "limited partners" under Code § 1402(a)(13).

The taxpayers in *Renkemeyer* claimed their respective interests in the law firm shared the characteristics of limited partnership interests because (i) their interests were designated as limited partnership interests in the law firm's organizational documents and (ii) the partners enjoyed limited liability pursuant to Kansas law. Hence, they argued, their distributive shares of the law firm's business income qualified for the Code § 1402(a)(13) exception. The Tax Court distinguished general partners from limited partners by explaining that "[g]eneral partners typically have management power and unlimited personal liability[, whereas] limited partners

lack management powers but enjoy immunity from liability for debts of the partnership."[13] The court held the attorneys were not limited partners.

The *Howell*[14] case, which was not discussed in the CCA, also sheds light on when an individual should be treated as a limited partner for purposes of Code § 1402(a)(13). This case involved the contention by a member of Intelemed, LLC, a limited liability company taxable as a partnership, that she was a "limited partner" whose share of earnings was not subject to self-employment tax pursuant to Code § 1402(a)(13). Intelemed was a medical technology company that provided software and hardware to hospitals. Although the taxpayer had no background in engineering or computer technology (unlike her husband, who was an employee of Intelemed), the IRS claimed there was evidence that, among other things, she signed contracts on behalf of Intelemed, made significant purchases for Intelemed, executed tax returns on behalf of Intelemed, and received a stream of payments consistent with compensation treatment. Finally, the IRS contended that the taxpayer's capital contributions to the LLC (all non-cash) "are not the type of contributions typically made by a passive investor." The taxpayer's capital contributions, as described in the LLC's operating agreement, were intellectual property, a business plan, and organizational design plans.

Intelemed deducted its payments to the taxpayer as guaranteed payments under Code § 707(c) on its Form 1065 tax returns for 2000 and 2001, and reported the payments as guaranteed payments on her Schedules K-1 for such years. The taxpayer did not report the payments as subject to self-employment tax on her Form 1040 tax returns for those years, but rather as partnership distributions.

The IRS set forth numerous arguments against the taxpayer, including that she "was an active participant in Intelemed and consequently she may not exclude the payments from her net earnings from self-employment under section 1402(a)(13)." The IRS's brief discusses *Renkemeyer* and quotes the legislative history of Code § 1402(a)(13), discussed above, regarding the kind of partner Congress had in mind for the self-employment tax exemption. Concomitantly, the court held that the legislative history "does not support the holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners" from self-employment taxes:

> In *Renkemeyer*,… we applied accepted principles of statutory construction to decide whether the taxpayers' partnership interests in a law firm should be considered limited partner interests for purposes of section 1402(a)(13), stating as follows:
>
> 'The insight provided reveals that the intent of section 1402(a)(13) was to insure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations … would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.'
>
> 'This Court held that the taxpayers were not limited partners for purposes of section 1402(a)(13) because the distributive shares received 'arose from legal services … [the taxpayers] performed on behalf of the law firm' and 'did not arise as a return on the partners' investment.'

The Tax Court held that the taxpayer was subject to self-employment tax, but did not strictly follow *Renkemeyer*. Although the opinion in

Howell quotes essentially the same portion of *Renkemeyer* as appears in the government's brief, the *Howell* opinion, in its analysis of the arguments, does not apply or even cite *Renkemeyer*.

CCA 201436049 does, however, discuss the decision in *Riether v. U.S.*[15] The Riethers were husband and wife and together they owned an LLC engaged in diagnostic imaging. The LLC paid the couple wages[16] and treated the excess of the income of the LLC over the amount paid as wages as their distributive share of partnership income. The Riethers did not pay NESE on their distributive share of LLC. The court characterized this reporting as trying "to treat themselves as employees for *some* of the LLC's earnings, by issuing themselves . . . wages while simultaneously treating themselves as partners for *the rest* of the LLC's earnings."[17] The court then focused on whether the limited partner exception of Code § 1402(a)(13) applied. The IRS asserted that NESE taxes applied to this income. The court held that the Riethers acted as general partners of the LLC and, accordingly, the limited partner exception did not apply.

APPLICATION TO THE LLC IN CCA 201436049

The IRS, relying on *Renkemeyer* and *Riether*, *supra*, ruled that the members of the Management Company could not rely on the limited partner exception of Code § 1402(a)(13) to avoid the imposition of NESE taxes on their distributive share of Management Company income. Dismissing the fact that certain of the members had paid substantial sums for their Management Company units, the IRS held that the Management Company earnings "are not in the nature of a return on capital investment . . . [but] are a direct result of the services rendered on behalf of the Management Company by its Partners." Accordingly, the IRS refused to allow the members of the Management Company escape the imposition of the NESE tax by reason of the application of the limited partner exception.

Code § 1411 and the Medicare Tax

For tax years beginning on or after January 1, 2013, Code § 1411 generally imposes a 3.8% Medicare tax (the "Medicare Tax") on net investment income ("NII") of U.S. individuals, trusts, and estates. [18] The term "NII" is defined for this purpose to mean any income falling into one of the following three categories (net of allocable expenses):[19]

1. Income from interest, dividends, annuities, royalties, and rents, except when those items are derived in the ordinary course of a trade or business not described in category 2.[20]
2. Other gross income derived in a trade or business involving trading in financial instruments or commodities or from an active trade or business in which the taxpayer is passive (for example, income from the taxpayer's investment in a business activity in which he does not materially participate).[21]
3. Net gain from the disposition of property, except when that property is held in a trade or business not described in category 2.[22]

The Medicare Tax applies to a trade or business if it is (i) a passive activity with respect to the taxpayer within the meaning of Code § 469 (the passive activity loss or PAL rules) or (ii) a trade or business of trading in financial instruments or commodities, as defined in Code § 475(e)(2).[23] If a taxpayer is active in a trade or business, he still will have NII from non-business income from interest, dividends, annuities, royalties, rents, and capital gains, minus allocable deductions. Code § 1411 does not define the term "trade or business." The proposed regulations under Code § 1411 specify that an activity is passive with respect to a taxpayer if it is (i) a trade or business within the meaning of Code § 162 and (ii) that trade or business is a passive activity within the meaning of Code § 469 as to the taxpayer.[24]

The determination of whether an item of gross income allocated to a taxpayer from a pass-through entity, such as a partnership or an S corporation, is derived from a trade or business in which the taxpayer materially participates is made at the taxpayer level(individual, estate, or trust) in accordance with the general principles of Code § 469.[25] The proposed regulations provide the following example that demonstrates the result in tiered pass-through entities:

> A, an individual, owns an interest in UTP, a partnership, which is engaged in a trade or business. UTP owns an interest in LTP, also a partnership, which is not engaged in a trade or business. LTP receives $10,000 in dividends, $5,000 of which is allocated to A through UTP. The $5,000 of dividends is not derived in a trade or business because LTP is not engaged in a trade or business. This is true even though UTP is engaged in a trade or business. Accordingly, the ordinary course of a trade or business exception described in paragraph (b) of this section does not apply, and A's $5,000 of dividends is net investment income under paragraph (a)(1)(i) of this section.[26]

THE PAL MATERIAL PARTICIPATION RULES

As noted above in the discussion of the Medicare Tax, a trade or business is not considered to be passive with respect to a taxpayer if the taxpayer "materially participates" in the conduct of such trade or business.[27] Code § 469(h)(1) provides that a taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.[28] Treasury Regulation § 1.469-5T provides additional guidance for individuals on the meaning of "material participation."

With respect to the term "participation," regulations provide that generally "any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity."[29] Treasury Regulation § 1.469-5T(f)(2)(ii)(A) provides, however, that work done by an individual in such individual's capacity as an investor in an activity shall not be treated as participation by the individual in the activity unless the individual is involved in the day-to-day management or operations of the activity. Work done by an individual in the individual's capacity as an investor in the activity includes studying and reviewing financial statements or reports on operations of the activity, preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use, and monitoring the finances or operations of the activity in a non-managerial capacity.[30]

The general "material participation" test of Code § 469(h)(1) has been refined by the more detailed regulatory tests contained in Temporary Treasury Regulation § 1.469-5T(a)(1)-(7). The Temporary Regulations provide seven alternatives for determining whether an individual should be treated as "materially participating" in an activity during a year:

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 of interests in the activity) 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 of interests in the activity) for such year.

4. The activity is a "significant participation activity" (within the meaning of Temp. Treas. Reg. § 1.469-5T(c)) for the taxable year,[31] and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.
5. The individual materially participated in the activity (determined without regard to Treas. Reg. § 1.469-5T(a)(5)) 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" (within the meaning of Treas. Reg. § 1.469-5T(d)), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.
7. Based on all of the facts and circumstances (taking into account the rules in Treas. Reg. § 1.469-5T(b)), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Code § 469(h)(2) treats losses from certain limited partnership interests as *per se* passive. Specifically, Code § 469(h)(2) provides "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."[32] For this purpose, Temporary Treasury Regulation § 1.469-5T(e)(3)(i) provides that a partnership interest is treated as a "limited partnership interest" under one of the following circumstances:

> (A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or (B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

The Temporary Regulations, however, provide an exception to the general presumption of non-material participation for limited partners. Specifically, Temporary Treasury Regulation § 1.469-5T(e)(2) provides that if the taxpayer is a limited partner of a limited partnership, but meets test (1), (5) or (6) of the seven material participation tests set forth in Temporary Treasury Regulation § 1.469-5T(a)(1)-(7) (see above), the taxpayer will be considered to materially participate in the activity of the partnership. Stated differently, a limited partner in a partnership can satisfy one of three tests ((1), (5) or (6)) to establish that he or she materially participates in the partnership's activity.

Another important exception (the so-called "general partner exception") is for a limited partner holding a general partner interest. Specifically, an individual holding a partnership interest will not be treated as a limited partner for the purpose of these rules if such individual is also a general partner in the partnership.[33] The general partner exception has been recently discussed by the courts in several cases involving taxpayers holding interests in limited liability companies (LLCs) and limited liability partnerships (LLPs).

In direct contrast to the position of the IRS in *Renkemeyer*, *Howell* and *Riether*, *supra*, the IRS has argued that LLC members (and, in one

case, LLP members) are "limited partners" for purposes of Code § 469 because of their limited liability under the relevant state law statutes. The courts disagreed with the IRS in all four cases.[34] In *Garnett v. Commissioner*, a case dealing with both LLPs and LLCs, Paul and Alicia Garnett owned interests in several limited liability companies and partnerships and tenancies-in-common that engaged in agricultural business operations. The Garnetts had direct interests in one LLP and one LLC and indirect interests in several other LLPs and LLCs. They were listed as limited partners in the LLP ventures and as limited liability company members in the LLCs. The IRS disallowed certain losses the Garnetts claimed related to their interests in the LLPs and LLCs, saying they failed to meet the participation requirements of Code § 469. The Garnetts argued that Code § 469(h)(2) did not apply to their situation because none of the entities were a limited partnership and because the Garnetts were general, rather than limited, partners. The IRS argued that the Garnetts' interests qualified as limited partnership interests and did not qualify as general partner interests for purposes of Code § 469.

The Tax Court first considered whether Code § 469(h)(2) is applicable to LLCs and LLPs, which were either new or nonexistent business entities when Code § 469 was enacted in 1986. The Tax Court began its analysis stating that Temporary Treasury Regulation § 1.469-5T(e)(3)(i) (see above) would appear to treat such LLC and LLP interests as a "limited partnership interests." Nevertheless, the Tax Court emphasized that if the general partner exception applies then the ownership interest "shall not be treated as a limited partnership interest." Stated differently, even if the taxpayers were to be treated as limited partners in the LLPs and LLCs, if they were to be treated also as general partners in these entities, then they would not be treated as limited partners for purposes of Code § 469. Thus, the issue addressed by the Tax Court was whether the general partner exception applied.

The Tax Court emphasized that Congress enacted Code § 469(h)(2) to address the statutory constraints on a limited partner's ability to participate in the partnership's business and that a member of an LLC or partners in an LLP are not similarly constrained. Because a member of an LLC or a partner in an LLP, unlike a limited partner in a limited partnership, is not prohibited by state law from participating in the partnership's business, he or she more closely resembles a general partner. As a result, the Tax Court concluded that a member of an LLC and a partner in an LLP should be treated as a general partner for purposes of Code § 469 and, as such, should be treated as a general partner for purposes of Temporary Treasury Regulation § 1.469-5T(e)(3)(ii).

The Tax Court further provided that the general partner exception is not expressly confined to the situation where a limited partner also holds a general partnership interest in a partnership. The exception provides that an individual who is a general partner is not restricted from claiming that he materially participated in the partnership. After examining the legislative history of Code § 469 and taking into account the lack of any prohibition regarding participation in management under state law, the Tax Court concluded that the general partner exception was broad enough to cover the activity of a taxpayer who holds an interest in an LLP or LLC and is authorized by state law to participate in managing the entity.

As the courts explained in these cases, in both LLCs and LLPs, the members/partners can maintain limited liability status while actively participating in the activity of the entity, as opposed to a limited partnership, where state laws generally prohibit the partners from actively participating in the business if they desire to maintain limited liability status.[35] The IRS argued in all cases that the important factor that should render a member in an LLC and

partner in an LLP a limited partner (and not general partner) for purposes of Code § 469(h)(2) is the limited liability awarded to both members in an LLC and partners in an LLP.[36] The courts, however, chose to focus on the right to participate in the business (which the courts consider as critical under Code § 469) rather then the limited liability.

THE TREATMENT OF GAIN FROM THE DISPOSITION OF INTERESTS IN PASS-THROUGH ENTITIES UNDER THE MEDICARE TAX

In general, gain from the disposition of an interest in a pass-through entity is not subject to the Medicare Tax on NII to the extent that the gain is attributable to assets held in the conduct of an active trade or business (other than the trading of stock, securities and commodities) in which the taxpayer materially participates. The statute, Code § 1411, does not directly address the taxation of gain from the disposition of interests in pass-through entities under the Medicare tax. The approach taken by the proposed Medicare regulations to reach this conclusion is circuitous.

Proposed Treasury Regulation § 1.1411-4(d)(3)(ii)(B)(1) provides that an interest in a pass-through entity, such as a partnership or an S corporation, is not considered to be property held in a trade or business. This rule, taken on a stand-alone basis, would imply that gain from the disposition of an interest in a pass-through entity would be subject to the Medicare Tax imposed on NII. Proposed Treasury Regulation § 1.1411-4(d)(3)(iii), however, provides that the gain that is potentially subject to the Medicare Tax is adjusted as provided in Proposed Treasury Regulation § 1.1411-7. Two requirements must be met in order for the modification rules in Proposed Treasury Regulation § 1.1411-7 to apply:

1. The pass-through entity must be engaged in at least one trade or business other than the trading of stocks, securities or commodities; and
2. The transferor of the interest in the pass-through entity must satisfy the material participation test with respect to the trade or business conducted by the pass-through entity.

Prop. Treas. Reg. § 1.1411-7(a)(2).

If the two conditions precedent necessary for the modification rule apply, the gain potentially subject to the Medicare Tax on NII is reduced as follows:

1. The pass-through entity is deemed to have disposed of all of its properties in a taxable transaction for the fair market value of the properties.
2. The pass-through entity computes the gain or loss that would be recognized in the deemed dispositions.
1. 3. The pass-through entity then allocates to the transferor the gain or loss that would be allocated to the transferor under the pass-through entity agreement as modified by applicable tax rules.
3. To the extent that there is a net gain attributable to assets used in a trade or business (other than trading stocks, securities or commodities) in which the taxpayer materially participates, such net gain is subtracted from the gain from the disposition of the interest in the pass-through entity that is potentially subject to the Medicare Tax on NII.[37]

Structuring to Alleviate the Burdens of the NESE and Medicare Taxes

If the Management Company in CCA 201436049 had been organized as a limited partnership instead of as an LLC, with the members holding limited partnership interests, the members would have been on a much stronger footing to avoid the application of the NESE tax. In

addition, for 2013 and years after, provided that each limited partner dedicated more than 500 hours towards the business of the Management Company, each limited partner should be able to avoid the application of the Medicare Tax to his or her allocable share of Management Company income. Notwithstanding the IRS's dismissive attitude towards the fact that members of the Management Company paid substantial sums for his or her interest in the Management Company, this fact supports the conclusion that the limited partner exception should apply to amounts allocated to members through their limited partnership interests. Assuming each limited partner paid cash for his or her limited partnership interest, *Howell* supports the conclusion that such a contribution would be of a type made by a passive investor. (Recall that the taxpayer's contribution to Intelemed was all non-cash and deemed "not the type of contributions typically made by a passive investor.")

This conclusion is supported by the fact that the *Howell* decision did not strictly rest on the conclusion that the LLC interest held by the taxpayer should not be treated as a limited partnership interest for purposes of Code § 1402(b)(13). The decision rested on the fact that the taxpayer made non-cash contributions that were tangible results of services, provided services to the partnership and received no other form of compensation.

The decisions in the PAL cases discussed above, *Garnett*, *Hegarty*, *Thompson* and *Newell*, *supra*, should not be relevant to the determination of whether the limited partnership interests held by a partner who also renders services should be treated as a limited partnership interests for purposes of Code § 1402(a)(13). First, on a substantive level, the purposes of the two tests are distinct. The NESE rules are testing as to whether income allocated to an individual should be treated as compensation for services. The purpose of the PAL rules is to deny the use of losses from passive investments against income earned from activities in which the taxpayer is actively involved. When the taxpayer is actively involved, regardless of the type of interest held by the taxpayer, the rationale for limiting the use of passive losses is not met. This conclusion is borne out by the general partner exception discussed above. Second, none of the PAL cases were cited by the courts in *Renkemeyer* and *Howell*, *supra*. If the treatment of LLC interests for PAL purposes was relevant for purposes of the limited partner exception contained in Code § 1402(a)(13), it is reasonable to expect that the Tax Court would have cited its holdings in the NESE cases. The conclusion on this point is reinforced by the 1997 Moratorium. This is clear evidence of Congressional intent that the combination of an individual providing services to an LLC and who holds an LLC interest should not be treated *per se* as a general partner with respect to the income earned through the limited partner interest for purposes of Code § 1402(a)(13).

Change in Law Risk

There have been a number of federal income tax bar developments that have recommended changes to the rules discussed above. In January 2013, the New York State Bar Association (the "NYSBA") released a report entitled, "Comments on the Application of Employment Taxes to Partners and the Interaction of the Section 1401 Tax with the New Section 1411" (the "NYSBA Social Security Tax Report"). In the NYSBA Social Security Tax Report, the NYSBA urged the IRS to re-adopt the 1997 Proposed Regulations. The recommendation extended to subjecting all partnership income to SECA taxes if the partner (limited or not) performed material services for the partnership. On April 15, 2013, Victor Fleisher, a tax law professor, published an article in the *New York Times* titled, "The Top 10 Private Equity Loopholes." In the article, Professor Fleisher noted that "Through careful structuring, some fund managers take their

income through a limited partnership in which they are technically 'limited partners' in the management company … Allocations to limited partners, however, are neither subject to the Medicare Tax as self-employment income nor as investment income under section 1411." Professor Fleisher goes on to recommend that Congress or the IRS adopt the recommendations in the NYSBA Social Security Tax Report.

Given the recent commentary regarding the potential for persons treated as partners for federal income tax purposes to structure their ownership in businesses in which they perform services to generate income that is not subject to either SECA taxes or Medicare taxes, it is possible that the law could change in the future. ◆

For more information about the topics raised in this article, please contact the author or your regular Mayer Brown contact.

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Endnotes

[1] Mark Leeds is a partner with the New York office of Mayer Brown. Mark will be addressing hedge fund tax issues at the 16th annual Financial Research Associates Effective Hedge Fund Tax Practices conference in New York on November 18, 2014.

[2] The CCA involved several hedge funds, all utilizing the same structure. For ease of presentation, however, we'll only refer to a single fund.

[3] Profits GP, which had a substantial interest in the master Fund's gains and losses but generally did not take part in the conduct or control of the activities of the Master Funds. The activities of Profits GP were not addressed in the CCA and will not be addressed in this article.

[4] It is likely that the amounts paid to members should not have constituted wages reported on an IRS Form W-2. In Rev. Rul. 69-184, the IRS held that the partners described were not employees of their partnership for employment tax purposes. Although no rationale was given in the ruling, the underlying GCM 34001 (Dec. 23, 1968) suggests that there was a concern that, for reasons of administrative convenience to the IRS, individuals should not be permitted to hold a dual capacity as employed and self-employed for employment tax purposes with respect to the same entity. A recent district court decision cited the 1969 ruling for the proposition that "'a partner who participates in the partnership business is 'a self-employed individual [and not an employee]. '" *Riether v. United States*, 919 F. Supp. 2d 1140 (D. NM. 2012), 112 AFTR 2d 2013-6074).

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

[6] *See* H.R. Rep. No. 95-702(I), pp. 40-41 (1977).

[7] The first LLC Act was adopted in Wyoming in 1976, but LLCs did not become truly widespread for over another decade.

[8] Additionally, an individual could not claim to be a limited partner if he or she has personal liability for the debts or claims against the partnership by reason of being a partner or has authority to contract on behalf of the partnership. The 1997 Proposed Regulations also provided that service providers in service partnerships (*e.g.*, law firms, accounting firms, and medical practices) may not be limited partners.

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

[10] H.R. 95-702 (Part 1), at 11 (1977).

[11] *Id.*

[12] 136 TC 137 (2011).

[13] Although the opinion does not state that the IRS concluded the partners were "general partners" for purposes of Code § 1402(a)(13), the IRS's brief (not cited or discussed in the opinion) makes it clear that the IRS would apply the state law characterization approach to subject all of the LLP's members to self-employment tax. Under this approach, the state law characterization of each member of the unincorporated limited liability entity as a general or limited partner would control for federal tax purposes. The IRS observed that (i) the partnership itself was organized and operated as an LLP, (ii) an LLP was a general partnership (not a limited partnership) under Kansas partnership law, and (iii) under that law, there were no limited partners in an LLP. Each attorney received his share of ordinary income from the law partnership as a general partner. Therefore, in the view of the IRS, the attorneys were not "limited partners" eligible for the Code § 1402(a)(13) exclusion from self-employment tax.

[14] TC Memo 2012-303.

[15] 919 F. Supp. 2d 1140 (D. NM. 2012, 112 AFTR 2d 2013-6074).

[16] The opinion in *Riether* notes that this reporting is inconsistent with the rule in Revenue Ruling 69-184 and that the IRS did not object to this reporting.

[17] Emphasis in original.

18 For individuals, the tax applies only if the individual's modified adjusted gross income for the tax year exceeds a

threshold amount equal to $200,000 (for single taxpayers) or $250,000 (for married taxpayers filing joint returns). See Section 1411(b).

[19] Code § 1411(c).

[20] Prop. Treas. Reg. § 1.1411-4(a)(1)(i).

[21] Prop. Treas. Reg. § 1.1411-4(a)(1)(ii), 5(a)(2).

[22] Prop. Treas. Reg. § 1.1411-5(a)(iii).

[23] Code § 1411(c)(2).

[24] Prop. Treas. Reg. § 1.1411-5(a).

[25] Preamble to REG-130507-11.

[26] Prop. Treas. Reg. § 1.1411-4(b)(3) Ex. 1.

[27] Code § 469(c)(1)(B).

[28] Code § 469(h)(1); Treas. Reg. § 1.469-5T(a)(7).

[29] Treas. Reg. § 1.469-5(f)(1).

[30] *See* Treas. Reg. § 1.469-5(f)(2)(ii)(B).

[31] An activity is a "significant participation activity" pursuant to Treas. Reg. § 1.469-5T(c) only if (1) the activity is a trade or business, (2) the individual participates in the activity for more than 100 hours during the year, and (3) the individual cannot establish material participation under any of the other material participation tests in the regulations.

[32] *See also* Temp. Treas. Reg. § 1.469-5T(e)(1) ("an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469… and the regulations thereunder to -- (i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership").

[33] *See* Temp. Treas. Reg. § 1.469-5T(e)(3)(ii).

[34] *See Garnett v. Commissioner*, 132 T.C. No. 19 (2009) (Tax Court held that a couple's interests in several LLPs and LLCs) do not qualify as limited partnership interests, and are not subject to the rule in Code § 469); *Hegarty v. Commissioner*, T.C. Summ. Op. 2009-153 (Oct. 6, 2009) (Tax Court held that a couple materially participated in the charter fishing business they operated through an LLC and their deductions for losses from that business were not subject to Code § 469); *Thompson v. United States*, 87 Fed. Cl. 728 (2009) (Court of Federal Claims held that Temp Treas. Reg. § 1.469-5T(e)(3) "… is simply inapplicable to a membership interest in an LLC," and even if it would apply to the taxpayer, the taxpayer's interest in the LLC "would best be categorized as a general partner's interest…", citing *Garnett v. Commissioner* with approval); *Newell v. Commissioner*, T.C. Memo 2010-23 (Tax Court has held that a couple properly deducted losses from an LLC in which the husband held a managing member interest, finding that he materially participated in the company and was not a limited partner for purposes of applying the passive activity loss rules of Code § 469). The IRS made the same argument in an older case, *Gregg v. United States,* 87 AFTR2d ¶ 2001-311 (U.S. District Court held that the limited partnership test in Code § 469 is obsolete when applied to LLCs and their members). It is worth noting that this litigating position is directly contrary to the position taken by the IRS in *Renkemeyer* and *Howell*, *supra*.

[35] *See e.g.*, *Gregg v. United States*, 186 F. Supp 2d at 1128.

[36] *See* e.g., *Thompson v. United States*, 87 Fed. Cl. 728 (2009), where the IRS argued that among the states allowing a limited partnership interest at the time section 469 was adopted, the key feature was limited liability. But the court refused to accept that view, holding that "limited liability is not the sine qua non of a limited partnership interest." Based on a review of the various limited partnership acts, the court said that the real determinative factor in creating a limited partnership interest was the level of participation in business control. "The tax code and the applicable regulations literally cannot be read to transfigure plaintiff's member interest in his LLC into one of a limited partnership," the court said.

[37] *Vice versa*, if there is a net loss from the disposition of assets used in a trade or business (other than trading stocks, securities or commodities) in which the taxpayer materially participates, the net loss is added to the overall gain recognized from the disposition of investment assets or assets used in a trade or business in which the taxpayer did not materially participate in.

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