IRS Self-Employment Campaign Heats Up

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In this article, the authors explain the implications of the Self-Employment Contributions Act compliance campaign launched by the IRS.

In 2017 the IRS Large Business and International Division began launching several compliance campaigns. Among five compliance campaigns rolled out in March 2018 was one the IRS referred to as "SECA Tax."

SECA stands for Self-Employment Contributions Act — a law first enacted in 1954 that requires self-employed individuals to contribute to Social Security and Medicare.[1] The SECA tax compliance campaign targets individual partners or members in state-law limited partnerships, limited liability companies, and limited liability partnerships. According to the description that accompanied the campaign rollout, the IRS's compliance concern is that "some individual partners, including service partners in service partnerships . . . have inappropriately claimed to qualify as 'limited partners' not subject to SECA tax."

LB&I recently released an IRS practice unit to guide IRS staff on self-employment tax and partners, which suggests that the SECA tax campaign could be heating up. There are rumors that the IRS is looking for one or more cases to serve as vehicles for additional litigation. This is not altogether surprising, given the lingering uncertainty in this area that remains even after some judicial opinions.

The SECA tax campaign followed two IRS victories (the latest in 2017) in Tax Court cases involving small, closely held, member-managed law firms — one an LLP and the other an LLC.[2] While litigating those cases, the IRS Office of Chief Counsel issued two advisory memoranda to LB&I. The first memorandum — issued in 2014 — concerned members of an investment-management LLC.[3] The second memorandum — issued in 2016 — focused on a food-service franchisee who was the operating manager and CEO of the LLC that owned the restaurants.[4] In both memoranda, the chief counsel took the position that the partners (that is, LLC members treated as partners for federal income tax purposes) were not limited partners for purposes of the relevant exclusion from SECA tax and were subject to SECA tax on their distributive shares from the LLCs. The IRS could also be targeting other industries.

SECA tax applies to net earnings from self-employment (NESE). The provision on which the SECA tax campaign focuses — section 1402(a)(13) — is one of several exclusions from NESE (and thus SECA tax). In the case of a partner in a partnership, section 1402(a) defines NESE to include the partner's distributive share of a partnership's ordinary business income described

[1] Today, the SECA tax comprises two separate taxes on self-employment income: (1) a 12.4 percent tax for Social Security (but not in excess of the contribution and benefit base determined under section 230 of the Social Security Act) and (2) a 2.9 percent tax for Medicare (which increases to 3.8 percent because the Affordable Care Act imposes an additional 0.9 percent Medicare tax on self-employment income over stated amounts).

[2] *Renkemeyer, Campbell, and Weaver LLP v. Commissioner*, 136 T.C. 137 (2011); and *Castigliola v. Commissioner*, T.C. Memo. 2017-62. The Department of Justice also won a case involving a doctor and his wife who were LLC members. *Riether v. United States*, 919 F. Supp. 2d 1140 (D.N.M. 2012). But the government's record in decided cases isn't perfect. In 2017 the IRS lost a case involving a surgeon who was a member in an LLC that operated a surgical center at which he occasionally performed procedures. *Hardy v. Commissioner*, T.C. Memo. 2017-16.

[3] ILM 201436049.

[4] ILM 201640014.

in section 702(a)(8) from any trade or business carried on by a partnership.[5] That is, a partner's distributive share of partnership income generally constitutes NESE subject to SECA taxes. But section 1402(a)(13) excludes from NESE:

> the distributive share of any item of income or loss of a *limited partner*, as such, other than guaranteed payments . . . to that partner for services 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. [Emphasis added.]

Stated differently, limited partners are not subject to SECA tax on their limited partnership distributions if those distributions are anything other than guaranteed payments for services.

In 1977 Congress enacted the statutory exclusion in section 1402(a)(13) to address a discrete concern that taxpayers were investing in LPs to capture additional Social Security benefits from passive investment income distributed to limited partners, which was not in keeping with the purpose of the Social Security system (that is, to replace lost earnings from work).[6] If that was the concern, however, then the statutory exclusion is both too narrow and too broad. In any event, the dynamic that existed when Congress enacted the statutory exclusion has shifted dramatically. And so has Congress.[7]

A major reason for the ongoing disputes is that the statutory exclusion references — but fails to define — "limited partner." Things were further complicated by the rise and growth in popularity of new types of state-law entities — LLCs and LLPs — in the decades that followed Congress's enactment of the statutory exclusion. Congress could not have had those hybrid entities — designed to provide the benefits of a partnership and a corporation — in mind when it enacted the statutory exclusion, and the IRS and the courts have struggled to apply the statutory exclusion to members of those entities. Although the courts have concluded that the statutory exclusion can apply to LLCs and LLPs treated as partnerships for federal tax purposes, the judicial opinions leave a host of unanswered questions. When it comes to state-law LPs (as opposed to LLCs and LLPs), it is unclear what the courts will do.[8]

For better or worse, the lack of guidance in this area is attributable to some degree to a regulatory void. A failed regulatory effort in the late 1990s (after another failed effort earlier that decade) resulted in proposed regulations that create a rebuttable presumption that all LLC members are limited partners and set forth tests for reclassifying LLC members as general partners.[9] The proposed regulations also targeted service partnerships. After a barrage of criticism against the regulations, Congress quickly issued a moratorium blocking them for a year. Treasury never finalized the proposed regulations, even after the moratorium lapsed. The IRS cannot enforce the proposed regulations but has stated that it will respect a taxpayer's limited partner status if the regulatory standards are satisfied. But the aforementioned judicial opinions have generated uncertainty over whether LLC or LLP members can even continue to rely on the proposed regulations.

As disputes in this area continue, it is unclear to what extent the IRS will seek to impose penalties. There is some evidence that the IRS

[5] SECA applies generally to gross income attributable to a trade or business unless otherwise excluded (*i.e.*, it does not apply to capital gains, dividends, interest, and, as discussed, some distributions to limited partners). In this context, "trade or business" has the same meaning as when used in section 162 (relating to trade or business expenses). Section 1402(b).

[6] *See* H. Rept. 95-702 (Part 1), at 11 (1977) (explaining that the limited partner distribution exclusion from Social Security coverage would exclude "earnings which are basically of an investment nature").

[7] The shift in congressional mentality is reflected in part by the elimination of the contribution-and-benefit base for the Medicare component of the SECA tax and the enactment of section 1411, which subjects net investment income to a 3.8 percent Medicare tax. Two types of trade or business income are subject to the net investment income tax: (1) passive activity income within the meaning of section 469 and (2) income of a trade or business trading in financial instruments or commodities.

[8] The IRS abandoned one case that involved a state-law LP's distribution to a limited partner who did not include the distribution in NESE. *See Sands v. Commissioner*, T.C. Dkt. No. 5650-15 (May 8, 2015). The IRS's reasons for abandoning that case are unclear.

[9] *See* 62 F.R. 1704 (Jan. 13, 1997) (stating that the proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state-law characterization of the entity); and prop. reg. section 1.1402(a)-2(h).

might not show the kind of restraint called for, given the state of the law. In the last case decided by the Tax Court on this topic, the IRS asserted a penalty but could not sustain it.[10] The court concluded that the taxpayers had acted with reasonable cause and in good faith in relying on their CPA and in light of a lack of administrative or judicial guidance when they filed their returns for the years before the court.[11]

In the absence of further congressional action or additional Treasury guidance, it is likely that any clarity in this area will come from court opinions that result from litigation arising out of the SECA tax campaign. ■

[10] *Castigliola v. Commissioner*, T.C. Memo. 2017-62.

[11] *Id.*