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by **Jeanne Sullivan, Karen Field, and Kelli Cacciotti, Washington National Tax, and Danchai Mekadenaumporn Global Mobility Services**

Jeanne Sullivan is a director in the Passthroughs group of Washington National Tax (“WNT”), former IRS senior technical reviewer (Passthroughs), and former U.S. Tax Court clerk. Karen Field is the principal-in-charge of the WNT Compensation and Benefits group and Kelli Cacciotti is an associate with that group. Danchai Mekadenaumporn is a manager with the Global Mobility Services Compensation and Benefits practice.

## The Application of SECA to Service LLCs and LLPs

**The tax regime of the Self Employment Contributions Act (“SECA”) applies to net income derived from self-employment (including by partners in partnerships and limited liability partnerships (“LLPs”), members in limited liability companies (“LLCs”), and sole proprietors). An entity may not realize that LLC or LLP members are subject to SECA. In the professions of health, law, consulting, accounting, and other specialized fields, individuals may be subject to SECA if they are members of a “service partnership” that is an LLC or LLP—even if they only occasionally provide services to the entity.**

### Background

LLCs and LLPs are business entities that can combine the pass-through taxation of a partnership with the limited liability of a corporation. Under the check-the-box regulations,<sup>1</sup> a domestic LLC or LLP is an eligible entity that may be treated as a partnership if it has two or more members or as a disregarded entity if it has a single member. In addition, a domestic LLC or LLP can elect to be treated as a corporation regardless of the number of members. If no election is made, a domestic LLC or LLP with two or more members is treated as a partnership by default.<sup>2</sup>

Under the Federal Insurance Contributions Act (“FICA”) rules, an employer and employee each pay half the total FICA due on an individual’s wages, and the employer may have to withhold “Additional Medicare tax” on the employee’s wages. SECA imposes a similar tax on an individual’s “net earnings from self-employment”<sup>3</sup> but the self-employed individual pays “both halves” of the SECA due. The SECA tax rate relating to old-age, survivor and disability insurance is 12.4 percent for amounts up to \$118,500 in 2016, while the rate relating to hospital insurance is 2.9 percent for all

<sup>1</sup> Section 301.7701-1 through 3 of the Procedure and Administration Regulations.

<sup>2</sup> Section 301.7701-3(a)-(b).

<sup>3</sup> Sections 1401 and 1402(a).

amounts below \$200,000. The self-employed person also pays an Additional Medicare tax of 0.9 percent on SECA income above \$200,000.<sup>4</sup>

Section 1402(a) generally defines “net earnings from self-employment” as gross income derived by an individual from his or her trade or business (less deductions) and the distributive share of income or loss from any trade or business carried on by a partnership of which the individual is a member.

As a general rule, all net earnings from self-employment are included in SECA unless specifically exempted under section 1402 or the underlying regulations. The SECA regulations generally define a “partnership” as any entity treated as a partnership for income tax purposes.<sup>5</sup> Section 1402(a) does not refer to or require that services be performed by a partner in order for the income to be treated as net earnings from self-employment. Moreover, as interpreted by the courts, a partner’s distributive share of trade or business income is generally included in the individual’s net earnings from self-employment, regardless of whether the individual performs services for the partnership.<sup>6</sup>

Section 1402(a)(13) excludes the distributive share of a “limited partner” from net earnings from self-employment, except with respect to guaranteed payments for services rendered or to be rendered. Neither the Code nor the regulations define a “limited partner” for this purpose. When section 1402(a)(13) was enacted in 1977, limited partners could not generally provide services to the partnership in which they invested. In fact, the legislative history indicates that the exception from SECA for limited partners was adopted in order to prevent investors who perform no services from earning credits for social security coverage from an investment.<sup>7</sup> Despite this purpose, however, the statutory language refers only to a “limited partner” and explicitly includes only guaranteed payments for services in a limited partner’s net earnings from self-employment.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

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<sup>4</sup> Sections 1401 and 1402(b).

<sup>5</sup> Section 1.1402(a)-2(f).

<sup>6</sup> *See, e.g., Perry v. Commissioner*, 67 T.C.M. 2966 (1994) (holding that a partner’s involvement in the operation of the oil wells was not the critical question in determining whether the income was subject to the SECA tax).

<sup>7</sup> H.R. Rep. No. 95-702(1) at 4197, 98 (1978)

## SECA's Application to LLCs and LLPs

During the years since adoption of section 1402(a)(13), many states have adopted limited partnership statutes that allow limited partners to perform services. In addition, new forms of business entities, such as LLCs, LLPs and limited liability limited partnerships ("LLLPs"), have become accepted. Finally, the check-the-box regulations were finalized and generally treat all of these domestic entities as partnerships for federal tax purposes if the entity has more than one member. As a result of the changes in state laws and the lack of guidance under section 1402, the circumstances under which members of these newer entities could qualify as limited partners for purposes of section 1402(a)(13) has been unclear.

In 1997, the IRS and Treasury attempted to provide clarity, issuing proposed regulation section 1.1402(a)-2(h) (the "1997 Proposed Regulations") to provide a definition of "limited partner" for purposes of the exclusion from the SECA tax provided in section 1402(a)(13). The 1997 Proposed Regulations provides that –

An individual is treated as a limited partner . . . unless the individual—

- (i) Has personal liability (as defined in §301.7701-3(b)(2)(ii) of this chapter) for the debts of or claims against the partnership by reason of being a partner;
- (ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or
- (iii) Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.<sup>8</sup>

The 1997 Proposed Regulations also provide rules that could allow individuals who are purely investors in a partnership or who own a separate class of interest that can be classified as an investment interest to be treated as limited partners.<sup>9</sup> The 1997 Proposed Regulations carve out a special exception for "service partners" in a "service partnership,"

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<sup>8</sup> Proposed section 1.1402(a)-2(h)(2).

<sup>9</sup> Proposed section 1.1402(a)-2(h)(3) and (4).

however, and provide that such partners cannot qualify as limited partners under the proposed regulations.<sup>10</sup> A service partner is one who provides more than de minimis services to or on behalf of a service partnership's trade or business, and a service partnership is defined as a partnership that provides service in the fields of "health, law, engineering, architecture, accounting, actuarial science or consulting."<sup>11</sup>

The 1997 Proposed Regulations caused controversy because the regulations defined a "limited partner" for purposes of section 1402(a)(13) in a way that did not depend upon the state-law characterization of the interest. As a result, the 1997 Proposed Regulations would have treated many individuals who are limited partners under state law (and perform significant services) as not qualified for the exclusion from SECA. Congress responded by providing for a moratorium on finalizing the 1997 Proposed Regulations for one year, until July 1, 1998. Despite the fact that the moratorium expired long ago, the 1997 Proposed Regulations were neither finalized nor withdrawn. Nevertheless, representatives of the IRS National Office have stated informally that taxpayers may rely on these regulations.<sup>12</sup> However, professionals providing services to a health, law, engineering, consulting, accounting, or actuarial science partnerships are likely to be treated as service partners under the 1997 Proposed Regulations and, as a result, would not be classified as "limited partners" for purposes of the SECA tax.

In a 2011 case, *Renkemeyer, Campbell, & Weaver LLP v. Commissioner*,<sup>13</sup> the Tax Court considered whether a member of a LLP was a "limited partner" for purposes of the exclusion from SECA and took a position similar to that of the 1997 Proposed Regulations with respect to service partners in a service partnership. The taxpayers in *Renkemeyer* were three law firm partners in an LLP who engaged in the day to day management and activities of the partnership by providing legal services, but had excluded the distributive shares of the law firm's net business income from SECA. The taxpayers argued that they were limited partners

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<sup>10</sup> Proposed section 1.1402(a)-2(h)(5).

<sup>11</sup> Proposed section 1.1402(a)-2(h)(6)(ii), (iii).

<sup>12</sup> See, e.g., *Miosi Says Court Losses Drove Addition of Material Participation in Guidance Plan*, 09 DTR G-2 (Jan. 15, 2010) (quoting Diana Miosi, Special Counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries)).

<sup>13</sup> 136 T.C. 137 (2011).

under section 1402(a)(13) because their interests (1) were designated as limited partnership interests in the firm's organizational documents, and (2) enjoyed limited liability under state law. Looking to the legislative history of section 1402(a)(13), the Tax Court noted that the intent of the statute was "to ensure 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."<sup>14</sup> The Tax Court further noted that the legislative history did not support excluding income from SECA for partners performing services for the partnership in their capacity as partners. The Tax Court noted that an LLP interest was not the same as a limited partner interest under state law and held that the taxpayers' distributive share of the trade or business income of the LLP was subject to the SECA tax. Though this case is directed specifically at a partnership in the legal profession, the discussion easily applies to other types of service partnerships as well.

Moreover, in a 2014 Chief Counsel Advice,<sup>15</sup> the IRS considered the general treatment of LLC members in an investment management business for purposes of SECA. In the facts of the CCA, a management company was originally formed as an S corporation. The shareholders of the S corporation were not subject to the SECA tax on the shareholders' distributive share of the trade or business income of the S corporation.<sup>16</sup> An LLC treated as a partnership (Mgt Co) was the successor to the S corporation and was the investment manager for a group of investment partnerships. The CCA states that Mgt Co was primarily responsible for carrying out extensive market research and the purchasing, managing, restructuring, and selling of funds' investment assets. Mgt's primary source of income was fees for these services and its partners worked full time providing those services. The IRS determined that the LLC members did not qualify as limited partners for purposes of section 1402(a)(13) and were subject to the SECA tax on their distributive share of trade or business income.

In contrast, if an individual is an actual limited partner in a state law limited partnership (not an LLC or an LLP), the individual is likely still exempt from the SECA tax under the language of section 1402(a)(13) even if the

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<sup>14</sup> *Renkemeyer*, 136 T.C. at 150.

<sup>15</sup> C.C.A. 201436049 (May 20, 2014).

<sup>16</sup> See Rev. Rul. 59-221, 1959-1 C.B. 225.

individual performs services for the entity (however, the exemption does not apply to any guaranteed income paid to the limited partner).

The primary objection to the 1997 Proposed Regulations was that the regulation attempted to treat a state-law limited partner as not exempt from SECA under section 1402(a)(13).<sup>17</sup> In 2005, the staff of the Joint Committee on Taxation acknowledged the disparate treatment of state law limited partners and LLC members treated as partners under the SECA tax and stated that the law should be changed.<sup>18</sup> The law has not been changed, however, and in a recent case filed in Tax Court—in which the government was apparently arguing that a limited partner in a limited partnership was subject to the SECA tax—the government withdrew its opposition and asked the court to grant the taxpayer’s requested relief.<sup>19</sup>

With both the IRS and the Tax Court suggesting that LLC and LLP members are not “limited partners” under section 1402(a)(13), the only way an LLC or LLP member may be generally exempt from SECA is to satisfy the limited partner definition under the 1997 Proposed Regulations. As noted above, a “service partner” in a “service partnership” under the 1997 Proposed Regulations does not satisfy this definition.

## Examples

To illustrate how SECA applies to service provider LLCs, consider the following examples.

ABC Accounting LLC has four members, all of whom are CPAs. Three of the members work full time for the accounting firm, and one is part time, but assists during busy seasons and generally works about 400 hours per year. All four members are subject to SECA because they are “service partners” in a “service partnership.” The part-time CPA provides more than “de minimis” service to a “service partnership” LLC and thus cannot use the limited partner exception.

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<sup>17</sup> See the “Sense of the Senate” resolution that provided for the moratorium: “[T]he Senate is concerned that the proposed change in the treatment of individuals who are limited partners under applicable State law exceeds the regulatory authority of the Treasury Department and would effectively change the law administratively without congressional action.” 143 Cong. Rec. 13,297 (1999).

<sup>18</sup> Options to Improve Tax Compliance and Reform Tax Expenditures, prepared by the Staff of the Joint Committee on Taxation, Jan. 27, 2005 (JCS-02-05).

<sup>19</sup> Sands v. Commissioner, Docket 5650-15 (May 8, 2015).

FGH Imaging LLC is owned by eight doctors and a corporation. Many of the doctors work for their own separate LLCs and separately bill their own clients, but they also provide services working with FGH, sending patients to use the medical equipment at FGH, and reading images produced by FGH. The doctors and corporations are not paid “salaries” by FGH and only share in net profits. Although the doctors are not specifically paid for services, as members in a service partnership (in the health field), they are generally subject to SECA on their distributive share of the profit if they are “service partners” and provide more than “de minimis” services to the service partnership.

BCD Manufacturing LLC is owned by four individuals and one S corporation. BCD Manufacturing LLC was formed to design, manufacture and market new fashion accessories. Three of the LLC members work for the entity and receive guaranteed income “salaries” while the fourth individual is an investor who also occasionally assists with marketing, working approximately 400 hours, but has no power to bind the entity. After the payment of the guaranteed payment “salaries” and certain additional allocations of profit payments to the 3 “active” members, the five owners split the profits based on ownership percentages. Under the 1997 Proposed Regulations, the individual who provides less than 500 hours of service, has limited liability and no power to bind the entity, meets the definition of a “limited partner” and is likely not subject to SECA. Note that BCD Manufacturing LLC is not a “service partnership.” In addition, the owner of the S corporation is not subject to SECA on the corporation’s distributive share of income from BCD Manufacturing LLC.<sup>20</sup>

## Conclusion

Most members of LLCs or LLPs that are within the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting included in the definition of a “service partnership” are unlikely to qualify as limited partners under section 1402(a)(13) or under the 1997 Proposed Regulation rules. These members must generally include their distributive share of the LLC’s trade or business income in their net income from self-employment for purposes of the SECA tax. An LLC or LLP member of a “service partnership” that provides de minimis or no service to the

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<sup>20</sup> See Rev. Rul. 59-221, 1959-1 C.B. 225.

services partnership (or any related entity) may be able to fit within the 1997 Proposed Regulation exemption (if the individual meets the other requirements) and be treated as exempt from SECA.

If the entity is instead a limited partnership, in a state that permits limited partners to provide services to the limited partnership, the limited partners, even though actively involved in the limited partnership, may be exempt from SECA, other than with respect to any guaranteed income paid to the members.



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