
Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of Limited Partner for Self-Employment Tax Purposes

REG-209824-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed amendments to the regulations relating to the self-employment income tax imposed under section 1402 of the Internal Revenue Code of 1986. These regulations permit individuals to determine whether they are limited partners for purposes of section 1402(a)(13), eliminating the uncertainty in calculating an individual's net earnings from self-employment under existing law. This document also contains a notice of public hearing on the proposed regulations.

DATES: Written comments must be received by April 14, 1997. Requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for May 21, 1997, at 10 a.m. must be received by April 30, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209824-96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-209824-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Auditorium, Internal Revenue Service building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulation, Robert Honigman, (202) 622-3050; concerning submissions and the hearing, Christina Vasquez, (202) 622-6808 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

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This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 1402 of the Internal Revenue Code and replaces the notice of proposed rulemaking published in the **Federal Register** on December 29, 1994, at 59 FR 67253 (EE-45-94, 1995-1 C.B. 853), that treated certain members of a limited liability company (LLC) as limited partners for self-employment tax purposes. Written comments responding to the proposed regulations were received, and a public hearing was held on June 23, 1995.

Under the 1994 proposed regulations, an individual owning an interest in an LLC was treated as a limited partner if (1) the individual lacked the authority to make management decisions necessary to conduct the LLC's business (the management test), and (2) the LLC could have been formed as a limited partnership rather than an LLC in the same jurisdiction, and the member could have qualified as a limited partner in the limited partnership under applicable law (the limited partner equivalence test). The intent of the 1994 proposed regulations was to treat owners of an LLC interest in the same manner as similarly situated partners in a state law partnership.

Public comments on the 1994 proposed regulations were mixed. While some commentators were pleased with the proposed regulations for attempting to conform the treatment of LLCs with state law partnerships, others criticized the 1994 proposed regulations based on a variety of arguments.

A number of commentators discussed administrative and compliance problems with the 1994 proposed regulations. For example, it was noted that both the management test and the limited partner equivalence test depend upon legal or factual determinations that may be difficult for taxpayers or the IRS to make with certainty.

Another commentator pointed out that basing the self-employment tax treatment of LLC members on state law

limited partnership rules would lead to disparate treatment between members of different LLCs with identical rights based solely on differences in the limited partnership statutes of the states in which the members form their LLC. For example, State A's limited partnership act may allow a limited partner to participate in a partnership's business while State B's limited partnership act may not. Thus, an LLC member, who is not a manager, that participates in the LLC's business would be a limited partner under the proposed regulations if the LLC is formed in State A, but not if the LLC is formed in State B. Commentators asserted that this disparate treatment is inherently unfair for federal tax purposes.

Some commentators argued for a "material participation" test to determine whether an LLC member's distributive share is included in the individual's net earnings from self-employment. The proposed regulations did not contain a participation test. Commentators advocating a participation test stressed that such a test would eliminate uncertainty concerning many LLC members' limited partner status and would better implement the self-employment tax goal of taxing compensation for services.

Other commentators argued for a more uniform approach, stating that a single test should govern all business entities (i.e., partnerships, LLCs, LLPs, sole proprietorships, et al.) whose members may be subject to self-employment tax. These commentators generally recognized, however, that a change in the treatment of a sole proprietorship or an entity that is not characterized as a partnership for federal tax purposes would be beyond the scope of regulations to be issued under section 1402(a)(13).

Finally, some commentators focused on whether the Service would respect the ownership of more than one class of partnership interest for self-employment tax purposes (bifurcation of interests). The proposed regulations treated an LLC member as a limited partner with respect to his or her entire interest (if the member was not a manager and satisfied the limited partner equivalence test), or not at all (if either the management test or limited partner equivalence test was not satisfied). Commentators, however, pointed to the legislative history of section 1402(a)(13) to support their argument that Congress only intended to tax a partner's distributive

share attributable to a general partner interest. Under this argument, a partner that holds both a general partner interest and a limited partner interest is only subject to self-employment tax on the distributive share attributable to the partner's general partner interest. This intent also may be inferred from the statutory language of section 1402(a)(13) that the self-employment tax does not apply to ". . . the distributive share of any item of income or loss of a limited partner, as such . . ." Based on this evidence, these commentators requested that the proposed regulations be revised to allow the bifurcation of interests for self-employment tax purposes.

After considering the comments received, the IRS and Treasury have decided to withdraw the 1994 notice of proposed rulemaking and to re-propose amendments to the Income Tax Regulations (26 CFR part 1) under section 1402 of the Code. Explanation of Provisions

The proposed regulations contained in this document define which partners of a federal tax partnership are considered limited partners for section 1402(a)(13) purposes. These proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity. Thus, the same standards apply when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC. In order to achieve this conformity, the proposed regulations adopt an approach which depends on the relationship between the partner, the partnership, and the partnership's business. State law characterizations of an individual as a "limited partner" or otherwise are not determinative.

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in § 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture,

accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.

By adopting these functional tests, the proposed regulations ensure that similarly situated individuals owning interests in entities formed under different statutes or in different jurisdictions will be treated similarly. The need for a functional approach results not only from the proliferation of new business entities such as LLCs, but also from the evolution of state limited partnership statutes. When Congress enacted the limited partner exclusion found in section 1402(a)(13), state laws generally did not allow limited partners to participate in the partnership's trade or business to the extent that state laws allow limited partners to participate today. Thus, even in the case of a state law limited partnership, a functional approach is necessary to ensure that the self-employment tax consequences to similarly situated taxpayers do not differ depending upon where the partnership organized.

The proposed regulations allow an individual who is not a limited partner for section 1402(a)(13) purposes to nonetheless exclude from net earnings from self-employment a portion of that individual's distributive share if the individual holds more than one class of interest in the partnership. Similarly, the proposed regulations permit an individual that participates in the trade or business of the partnership to bifurcate his or her distributive share by disregarding guaranteed payments for services. In each case, however, such bifurcation of interests is permitted only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners under the proposed regulation (without regard to the bifurcation rules) and who own a substantial interest in the partnership. Together, these rules exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership.

Proposed Effective Date

These regulations are proposed to be effective beginning with the individual's first taxable year beginning on or after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, May 21, 1997, at 10 a.m. in the Auditorium, Internal Revenue Service building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Service building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 14, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 30, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Robert Honigman of the Office of Assistant Chief Counsel (Pass-throughs & Special Industries). How-

ever, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1402(a)-2 is amended by:

1. Revising the first sentence of paragraph (d).
 2. Removing the reference “section 702(a)(9)” in the first sentence of paragraph (e) and adding “section 702(a)(8)” in its place.
 3. Revising the last sentence of paragraph (f).
 4. Revising paragraphs (g) and (h).
 5. Adding new paragraphs (i) and (j).
- The revisions and additions read as follows:

§ 1.1402(a)-2 *Computation of net earnings from self-employment.*

* * * * *

(d) * * * Except as otherwise provided in section 1402(a) and paragraph (g) of this section, an individual's net earnings from self-employment include the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by each partnership of which the individual is a partner. * * *

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(f) * * * For rules governing the classification of an organization as a partnership or otherwise, see §§ 301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

(g) *Distributive share of limited partner.* An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.

(h) *Definition of limited partner*—(1) *In general.* Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.

(2) *Limited partner.* An individual is treated as a limited partner under this paragraph (h)(2) 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.

(3) *Exception for holders of more than one class of interest.* An individual holding more than one class of interest in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—

- (i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,
- (ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

(4) *Exception for holders of only one class of interest.* An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

- (i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and
- (ii) The individual's rights and obligations with respect to the specific class

of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

(5) *Exceptio n for servic e partner s* *servic e partnerships* An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

(6) *Additional definitions* Solely for purposes of this paragraph (h)—

(i) A *class of inte res* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A *servic e partne r* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii) A *servic e partnersh ip* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv) A *substantia l inte rest in a class of inte res* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

(i) *Example* . The following example illustrates the principles of paragraphs (g) and (h) of this section:

Example .(i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute \$1x for one LLC unit. B contributes \$2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a

guaranteed payment of \$6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of \$10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) *Applicatio n of genera l rule of paragraph (h)(2) of this section* A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) *Distributiv e sha re not include d in net earnings from self-employem t unde r paragrap h (h)(4) of this section* B's guaranteed payment of \$6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participate in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) *Distributiv e sha re include d in net earnings from self-employem t* C's guaranteed payment of \$10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

(j) *Effectiv e date* Paragraphs (d), (e), (f), (g), (h), and (i) are applicable beginning with the individual's first taxable year beginning on or after the date this

section is published as a final regulation in the **Federal Register**.

Margaret Milner Richardson,
Commissione r of Interna l Revenue.

(Filed by the Office of the Federal Register on January 10, 1997, 8:45 a.m., and published in the issue of the Federal Register for January 13, 1997, 62 F.R. 1702)