IRS Issues Chief Counsel Advice on Self-Employment Tax

September 2014

Overview

On September 5, 2014, the IRS released a Chief Counsel Advice (ILM 201436049), which discusses the application of self-employment tax to members of a limited liability company providing investment management services. The CCA concludes that all members of the limited liability company (the "LLC") are subject to self-employment tax on their distributive shares of income of the LLC. The CCA potentially implies that the IRS might raise the self-employment tax issue when it is auditing fund managers and might call into question whether limited partners in management companies can avoid being subject to self-employment tax.

Facts in the CCA

The LLC, which is under examination by the IRS, is treated as a partnership for federal tax purposes and serves as investment manager to several investment partnerships (i.e., funds). The LLC manages and controls the investment activities of each fund that it manages. Members of the LLC provide extensive services to the funds. The LLC is paid quarterly management fees based on assets under management. Some members were initial members of the LLC and other members purchased interests at a later time at the then net book asset value. The members are paid wages by the LLC, which the management company states are reasonable compensation, and are also allocated distributive share income and paid minimal guaranteed payments for health insurance and parking benefits. All the members are treated as limited partners for self-employment tax and therefore do not pay any self-employment tax on their distributive share income.

Analysis in the CCA

The CCA analyzes whether Section 1402(a)(13) of the Internal Revenue Code of 1986, as amended (the "Code"), applies to the income allocated to the members. Section 1402(a)(13) provides an exception to self-employment tax for limited partners. Section 1402 does not define what a limited partner is. The CCA looks at legislative history and focuses on an excerpt that the CCA views as intending that the exception for limited partners was to exclude earnings which are basically of an investment nature. The CCA refers to Renkemeyer, which is a 2011 Tax Court case that addressed self-employment tax in the context of a law firm that was a limited liability partnership and concluded that the partners were not limited partners for self-employment tax purposes. The CCA also refers to Riether, a 2012 case addressing self-

employment tax in the context of a limited liability company. The CCA concludes that the members are not limited partners apparently because they performed extensive investment and operational management services.

Impact of the CCA

It is too soon to determine what, if any, impact the CCA will have. The CCA is not binding or precedential. No regulations or rulings have been issued. The CCA refers to regulations which were proposed in 1997; however, Congress imposed a temporary moratorium on finalizing those regulations and they expired and were never finalized. The CCA does not address a fact pattern where the management company is a limited partnership or where there are substantial guaranteed payments (although the wages paid in the CCA may have been substantial). The statute has not changed and this limited partnership position has been a longstanding position taken by many taxpayers and known about by the IRS for many years. Thus, we anticipate that most managers will not change their tax return position based merely on the CCA (especially for 2013 because those returns, if they have not been filed yet, are due very shortly). Managers might consider electing to be an S corporation but that may raise significant tax and non-tax issues.

In short, managers should be aware that the position regarding self-employment tax and Section 1402(a)(13) may be subject to challenge on audit. We will continue to monitor any developments regarding this issue.

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