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Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base

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I. Introduction

Income from employment (FICA)[1] and self-employment (SECA)[2] taxes represents more than one-third of annual federal

1. *See* Federal Insurance Contributions Act (FICA), I.R.C. §§ 3101–3128 (2012) (describing employment taxes (sometimes called "payroll taxes"), which are paid by employers and employees based on employees' wages).

2. *See* Self-Employment Contributions Act (SECA), I.R.C. §§ 1401–1403 (2012) (describing self-employment taxes, which are paid by self-employed individuals on their net income from self-employment).

revenue.[3] Likewise, Social Security and Medicare—the social insurance programs that these taxes support—account for more than one-third of all federal government spending each year.[4] The government expects Medicare and Social Security expenditures to rise at an accelerated clip in the coming decades due to demographic changes and increasing health care costs.[5] Expenditures on these programs already exceed annual revenue from employment and self-employment taxes,[6] and the Congressional Budget Office (CBO) projects that the deficits will worsen.[7] While our country undoubtedly needs broader policy changes to address those deficits, there is no reason to neglect opportunities to maximize employment and self-employment tax revenues by effectively enforcing existing tax law until those changes arrive.

Because the employment tax regime targets wages arising from formal employer–employee relationships and utilizes a

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3. *See* Tax Policy Ctr. (Urban Inst. & Brookings Inst.), *TPC Tax Topics: Payroll Taxes*, TAX POL'Y CENTER, http://www.taxpolicycenter.org/taxtopics/Payroll-Taxes.cfm (last visited Sept. 15, 2013) (noting that FICA and SECA taxes accounted for 34.5% of all federal revenue in 2012) (on file with the Washington and Lee Law Review). FICA taxes produce the vast majority of this revenue, generating more than 30% of federal revenue in 2011 compared with approximately 2% from SECA taxes. CONG. BUDGET OFFICE, PUB. NO. 4168, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX 1 (2012) [hereinafter CBO SECA REPORT]. This ratio "closely reflects" the ratio of wage earners to self-employed individuals. *Id.*

4. *See* CTR. ON BUDGET & POLICY PRIORITIES, POLICY BASICS: WHERE DO OUR FEDERAL TAX DOLLARS GO? 1 (2013), http://www.cbpp.org/files/4-14-08tax.pdf (providing spending figures for fiscal year 2012).

5. *See* CONG. BUDGET OFFICE, PUB. NO. 4507, THE 2012 LONG-TERM BUDGET OUTLOOK 12–13, 45, 65 (2012) (projecting increases in expenditures due to rising health care costs and increases in the number of beneficiaries as baby boomers age).

6. *See* CONG. BUDGET OFFICE, PUB. NO. 4520, THE 2012 LONG-TERM PROJECTIONS FOR SOCIAL SECURITY: ADDITIONAL INFORMATION 1 (2012) ("In 2011, [Social Security] outlays exceeded tax revenues by 4 percent, and CBO projects that the gap will average about 10 percent of tax revenues over the next decade.").

7. *See* Soc. Sec. & Medicare Bds. of Trs., *A Summary of the 2013 Annual Reports*, U.S. SOC. SECURITY ADMIN., http://www.ssa.gov/oact/trsum/index.html (last visited Sept. 21, 2013) (reporting revenues and expenditures for Social Security and Medicare in recent years and projecting deficits over the next several decades) (on file with the Washington and Lee Law Review).

structured, uniform withholding system, it is easier to enforce.[8] Because the self-employment tax regime operates outside of a formal wage system, its tax base is more porous. That is, characterization of income may allow taxpayers to shield the return on self-employed labor from the SECA base.[9] The CBO estimates that the self-employment tax base captures approximately three-fourths of the income that would be taxed if those workers were subject to the FICA tax regime.[10]

Income generated through partnerships and other unincorporated business entities such as limited liability companies (LLCs) and limited liability partnerships (LLPs) presents particular self-employment tax enforcement challenges. Because Congress and the Treasury Department have failed to update certain tax laws and regulations to address the evolution of the unincorporated business entity landscape over the past three decades, income that arguably should be part of the self-employment tax base eludes taxation.[11] Service-providing professionals such as lawyers, doctors, and accountants, who often organize their businesses as unincorporated entities, can exploit these rules, essentially permitting those taxpayers to elect out of the self-employment tax regime through choice of entity and ownership structure.[12]

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8. *See* Patricia E. Dilley, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 TAX LAW. 65, 93–96 (2000) (comparing the employment and self-employment tax systems and noting differences that make employment taxes easier to collect).

9. *See id.* at 96 (noting that the taxpayer alone controls classification of income as subject to self-employment tax, which creates a "greater potential" for understatement of self-employment income and underpayment of self-employment taxes); *see also* Richard Winchester, *The Gap in the Employment Tax Gap*, 20 STAN. L. & POL'Y REV. 127, 127 (2009) (noting that the law permits individuals who conduct their business through an unincorporated entity to "artificially exclude from the employment tax base amounts that would otherwise be included if they operated as a sole proprietor").

10. CBO SECA REPORT, *supra* note 3, at iv.

11. *See infra* Part III (explaining how the self-employment tax base fails to capture all labor income due to the nature of unincorporated businesses); *infra* Part IV.E (describing the problems presented by the changes to the unincorporated business landscape).

12. *See* CBO SECA REPORT, *supra* note 3, at 2 (describing how differences in the FICA and SECA tax regimes can "affect an individual's decision about whether to be self-employed" and "influence the choice of how to organize a firm"); *see also* Winchester, *supra* note 9, at 128 ("Depending on the business

Internal Revenue Code § 1402(a)(13),[13] which excludes from the self-employment tax base the distributive share of any "limited partner" (less guaranteed payments for services rendered),[14] represents one such loophole-creating rule and is the focus of this Note. Some unincorporated business owners now exploit the limited partner exclusion—originally enacted to *prevent* taxpayers from obtaining Social Security benefits improperly by paying self-employment taxes[15]—to avoid paying the tax.[16] Neither the Internal Revenue Code nor the Treasury Regulations define "limited partner" or provide guidance on how to apply this provision to modern unincorporated businesses that no longer neatly fit within the 1977 limited partnership framework.[17]

Part II of this Note lays the foundation for analyzing this problem by discussing the history of Social Security and Medicare and of the employment and self-employment tax regimes.[18] This Part also discusses how the legislative history of the Social Security Act of 1935[19] reveals several policy choices that have shaped the development of both the Social Security program and the tax regimes that finance it.[20] Part III explains why one of these policy choices—the decision to fund Social Security through

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entity that she uses, a self-employed individual can substantially reduce her employment tax liability and often eliminate it entirely.").

13. I.R.C. § 1402(a)(13) (2012).

14. *See id.* ("[T]here shall be excluded the distributive share of any item of income or loss of a limited partner . . . other than guaranteed payments . . . to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are . . . remuneration for those services.").

15. *See infra* notes 134–36 and accompanying text (explaining Congress's motivation to enact the limited partner exclusion).

16. *See* JOINT COMM. ON TAXATION, PUB. NO. JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 98–99 (2005) ("The uncertainty in treatment creates an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument is contrary to the spirit and intent of the employment tax rules.").

17. *Infra* note 153 and accompanying text.

18. *Infra* Part II.

19. Social Security Act (Old Age Pension Act), Pub. L. No. 74-271, 49 Stat. 620 (1935) (codified as amended in scattered sections of 42 U.S.C.).

20. *Infra* Part II.A.

a contributory tax on labor income—presents special challenges in the unincorporated business context.[21]

Part IV discusses the limited partner exclusion, explaining both the impetus for its enactment and Congress's rationale for using limited partners as a dividing line to separate labor income and capital income.[22] This Part also puts § 1402(a)(13) in context by describing the unincorporated business landscape as Congress viewed it in 1977 and chronicling the ways the business landscape has changed.[23] These changes, especially the proliferation of LLCs (whose owners are neither "general partners" nor "limited partners" under state law), have created uncertainty for taxpayers and produced numerous problems applying the exclusion.[24] This Part also describes the Internal Revenue Service's (IRS) mechanical interpretation of § 1402(a)(13)—affirmed by courts through the years—that classification as a "general partner" or "limited partner" for § 1402(a)(13) purposes depends only on one's classification under state law.[25]

Part V focuses on the IRS's attempts to address these problems by proposing regulations in the mid-1990s[26] and explains how Congress eventually thwarted these problem-solving attempts by enacting a regulatory moratorium in 1997.[27]

Part VI discusses the 2011 Tax Court case of *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*,[28] which exemplifies the potential for abuse created by the lack of definitive guidance on how to apply the limited partner exclusion to unincorporated business entities other than limited partnerships.[29] *Renkemeyer*

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21. *See infra* Part III (discussing difficulties in separating labor income and capital income).

22. *Infra* Part IV.A–B.

23. *See infra* Part IV.B (describing the business landscape in 1977); *infra* Part IV.D (describing the evolution of unincorporated business entities since 1977).

24. *See infra* Part IV.E (describing these problems).

25. *See infra* Part IV.C (discussing cases decided using this standard).

26. *Infra* Part V.A–B.

27. *Infra* Part V.C.

28. 136 T.C. 137 (2011).

29. *Infra* Part VI.A (explaining the taxpayer's aggressive position and the Tax Court's response).

garnered attention from tax practitioners—not so much for its result, but rather for the Tax Court's reasoning in reaching the result.[30] The court gave little weight to precedent that would have easily decided the case and instead focused on the partners' level of participation to determine whether they qualified as limited partners.[31] The court's rationale left practitioners wondering if material participation is the new dividing line—one that may jeopardize the ability of some state-law-designated limited partners to utilize the exclusion.[32]

In Part VII, this Note advocates for adoption of a material participation standard to interpret the limited partner exclusion, noting the limitations of this approach.[33] Part VIII concludes this Note by discussing possible mechanisms for adopting such a standard.[34]

II. Historical Foundations of the Self-Employment Tax

A. Landmark Legislation: Social Security Act of 1935

To appreciate the current dilemma regarding exclusion or inclusion of income for self-employment tax purposes, it is helpful to understand the basic history of the social insurance programs funded by employment and self-employment tax revenue. FICA and SECA taxes provide the majority of funding for three programs: (1) the Old Age and Survivors' Insurance program, which provides cash benefits to retired workers and surviving dependents of deceased workers; (2) the Disability Insurance program, which provides cash benefits to disabled workers and their dependents; and (3) Hospital Insurance, which funds health insurance benefits popularly known as Medicare.[35]

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30. *See infra* Part VI.B (describing reactions to *Renkemeyer*).

31. *See infra* notes 289–301 and accompanying text (describing the court's analysis).

32. *See infra* notes 309–10 and accompanying text (describing this concern).

33. *Infra* Part VII.

34. *Infra* Part VIII.

35. Dilley, *supra* note 8, at 65 & n.2, 69.

Responding to growing concern about income insecurity following the Great Depression,[36] Congress enacted the Social Security Act[37] in 1935, which established Social Security, the cash benefits program for retired workers.[38] Social Security was not the first federal program to provide direct assistance to citizens and their families,[39] but it was the first program to utilize a social insurance approach.[40] Rather than obtaining benefit eligibility by demonstrating financial need, individuals gained eligibility for Social Security (and later, Medicare) benefits by working in employment covered by the Social Security Act[41] and by making contributions to the Social Security program.[42] Cash benefit amounts are not formally means-tested;[43] instead the

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36. *See* Lawrence H. Thompson & Melinda M. Upp, *The Social Insurance Approach and Social Security*, *in* SOCIAL SECURITY IN THE 21ST CENTURY 3, 3–4 (Eric R. Kingson & James H. Schulz eds. 1997) (explaining the need for Social Security).

37. Social Security Act (Old Age Pension Act), Pub. L. No. 74-271, 49 Stat. 620 (1935) (codified as amended in scattered sections of 42 U.S.C.). Although the Act passed in 1935, the government did not begin collecting payroll taxes until 1937 and did not begin disbursing benefits until 1942. Martha A. McSteen, *Fifty Years of Social Security*, U.S. SOC. SEC. ADMIN. SOC. SECURITY HIST., http://www.ssa.gov/history/50mm2.html (last visited Nov, 4, 2013) (on file with the Washington and Lee Law Review).

38. *See* 49 Stat. at 620 (describing the Act's purposes, including "[t]o provide for the general welfare by establishing a system of Federal old-age benefits"); *see also* DENNIS W. JOHNSON, THE LAWS THAT SHAPED AMERICA: FIFTEEN ACTS OF CONGRESS AND THEIR LASTING IMPACT 176–77 (2009) (describing the components of the Social Security Act of 1935).

39. *See* JOHNSON, *supra* note 38, at 178 (describing the public's familiarity with federal assistance programs).

40. *See* Thompson & Upp, *supra* note 36, at 4–6 (providing historical context to Congress's choice to build Social Security on a social insurance model).

41. *See* 42 U.S.C. § 414(a)(2) (2012) (stating that forty quarters of qualifying work establishes basic eligibility for lifetime benefits). For a quarter to qualify, the worker must earn a certain amount, set by the government each year, based on average total covered wages. *Id.* § 413(d)(2). For the 2013 tax year, a worker who earns $1,160 in one quarter receives one credit. SOC. SEC. ADMIN., FACT SHEET: 2013 SOCIAL SECURITY CHANGES 1 (2012), *available at* http://www.socialsecurity.gov/pressoffice/factsheets/colafacts2013.htm.

42. *See* Thompson & Upp, *supra* note 36, at 7 ("Eligibility for benefits under social insurance programs [such as Social Security] rests, in part, on current or previous contributions by the individual, the individual's employer, or both.").

43. *See id.* at 10 (explaining that means-tested programs such as food stamps and Medicaid pay benefits "to claimants who first demonstrate limited

program calculates benefit amounts using a percentage of a worker's lifetime average earnings.[44] This structure—tying work to benefits—distinguished Social Security from other social programs.

Although Social Security initially covered only workers in "commerce and industry," which included approximately 60% of jobs at that time,[45] President Franklin D. Roosevelt favored including all Americans in the program from the start.[46] Aside from his desire to protect all Americans from the dangers of income insecurity, President Roosevelt recognized that without compulsory, universal participation and coverage, the program would not be able to generate enough revenue to cover its obligations.[47]

Working toward this universal coverage goal, Social Security coverage expanded over the next two decades, adding survivors of deceased workers,[48] previously excluded wage-earning workers,[49]

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economic resources" and typically have "nothing to do with prior earnings or payment of taxes"). Social Security benefits are, however, indirectly means-tested in that only a portion of higher income individuals' benefits are excluded from gross income. *See* I.R.C. § 86 (2012) (describing taxation of Social Security benefits). Through the income tax, higher income beneficiaries return a portion of their benefits to the government.

44. *See* 42 U.S.C. § 415 (providing the benefit determination formula). The benefit determination formula, however, is "weighted to provide a higher level of replacement of prior earnings for low earners." Dilley, *supra* note 8, at 69 n.15. Although Medicare eligibility also requires forty quarters of qualifying employment, medical costs—not prior earnings—determine Medicare benefit amounts. *See id.* (noting this difference).

45. LARRY W. DEWITT, DANIEL BÉLAND & EDWARD D. BERKOWITZ, SOCIAL SECURITY: A DOCUMENTARY HISTORY 4 (2008).

46. *See* JOHNSON, *supra* note 38, at 183 (noting a statement made by President Roosevelt in a cabinet meeting during the early stages of planning the new program that would become Social Security).

47. *See* Eric R. Kingson & James H. Schulz, *Should Social Security be Means-Tested?*, *in* SOCIAL SECURITY IN THE 21ST CENTURY, *supra* note 36, at 41, 43–44 (describing problems that would result if taxpayers could "opt-out" of the Social Security program).

48. *See* Social Security Act Amendments of 1939, Pub. L. No. 76-379, 53 Stat. 1360 (codified at 42 U.S.C. §§ 1306–1307 (2012)) (adding survivor benefits).

49. *See* Social Security Act Amendments of 1950, Pub. L. No. 81-734, 64 Stat. 477 (codified at 42 U.S.C. §§ 411–418, 1308, 1351–1355 (2012)) (expanding coverage to wage-earning farm and domestic workers and some federal government workers).

disabled citizens who could not work,[50] and the self-employed.[51] Congress introduced the Hospital Insurance (HI) program in 1964.[52]

B. Funding Social Security: Affirming the Tie Between Benefits and Labor

Like the universal coverage goal, the commitment to tying benefits to a person's work played a vital role in Social Security's creation and still drives the program's financing structure today. In discussions leading to the Social Security Act's enactment, President Roosevelt emphasized that Social Security should be a form of social insurance, not welfare, as "[w]elfare, then and now, carried negative connotations; insurance did not."[53] He noted that "[u]nder an insurance program, work and savings are encouraged, and individuals would not be on the dreaded 'dole.'"[54] J. Douglas Brown, a Princeton University professor who chaired the first Advisory Council on Social Security (assembled by President Roosevelt to design Social Security),[55] found it both "politically and psychologically reasonable" to limit eligibility for benefits to workers who contributed into the system.[56] The benefits–labor connection, Brown said, gave contributing workers "a broad equity in a system—a sense of right—that for the

50. *See* Social Security Amendments of 1956, Pub. L. No. 84-880, 70 Stat. 807 (codified as amended in scattered sections of 42 U.S.C.) (adding disability benefits); *see also* JOHNSON, *supra* note 38, at 177 ("In 1956, Congress incorporated disability insurance and later created SSI, the Supplemental Security Income program for the indigent aged not eligible for regular Social Security benefits.").

51. *See* Social Security Act Amendments of 1950, Pub. L. No. 81-734, 64 Stat. 477 (codified at 42 U.S.C. §§ 411–418, 1308, 1351–1355 (2012)) (extending coverage to nonfarm, nonprofessional, self-employed individuals); Social Security Amendments of 1954, Pub. L. No. 83-761, 68 Stat. 1052 (codified at 42 U.S.C. §§ 176, 420–422 (2012)) (extending coverage to self-employed farmers and most self-employed professionals).

52. *See* Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286 (codified as amended in scattered sections of 42 U.S.C.) (adding Medicare).

53. JOHNSON, *supra* note 38, at 184.

54. *Id.*

55. *See* J. DOUGLAS BROWN, ESSAYS ON SOCIAL SECURITY viii (1977) (describing his service on the Advisory Council).

56. *Id.* at 26.

contributor distinguished benefits from relief."[57] Affirming President Roosevelt's thinking, Brown agreed that a social insurance program based on work would earn greater popular and political appeal than a welfare system because it was "individualized" and "suited the American mores of paying for one's own ticket."[58]

Believing it wrong to "saddle future generations with expenditures accrued in the 1940s," President Roosevelt demanded that Social Security be entirely self-financing and favored a payroll tax on wages over general revenues.[59] Congress ultimately sided with President Roosevelt and chose a payroll tax on wages over an increase in the general income tax for several reasons. First, payroll taxes would supply a revenue source independent of income and other taxes.[60] Next, Congress viewed the general income tax as an "uncertain means of collecting money for social projects."[61] At the time, the income tax had a narrow base—95% of Americans paid no income taxes—which limited its expansion potential and made it "unreliable" for covering Social Security's future obligations.[62] Most important, a wage tax reinforced the program's labor–benefits link.

Social Security's architects believed that financing the program through a payroll tax had political as well as practical expediency in that workers would "enthusiastically buy into the idea that it was their money that went in and their money that would be available at retirement time."[63] Further, as President Roosevelt put it, a wage tax would "give the contributors a legal,

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57. *Id.*

58. *Id.*

59. DEWITT ET AL., *supra* note 45, at 3; *see also* SHEILA BURKE, ERIC KINGSON & UWE REINHARDT, SOCIAL SECURITY AND MEDICARE: INDIVIDUAL VS. COLLECTIVE RISK AND RESPONSIBILITY 38 (2000) ("The self-financing feature of the program, first proposed by Franklin Roosevelt in 1935, became another of its celebrated virtues.").

60. *See* Edward D. Berkowitz, *The Historical Development of Social Security in the United States*, *in* SOCIAL SECURITY IN THE 21ST CENTURY, *supra* note 36, at 22, 24 (noting this characteristic).

61. *Id.*

62. *Id.*

63. JOHNSON, *supra* note 38, at 186. Note that an individual's earnings recorded—not taxes paid—determine Social Security benefit amounts. *See* 42 U.S.C. § 415 (2012) (providing the formulas for computing benefit amounts).

moral, and political right to collect their pensions," having already paid taxes into the system.[64] This right would safeguard the benefits from any future politicians' attempts to scrap Social Security.[65]

The Federal Insurance Contributions Act[66] authorized the payroll tax, splitting the nominal tax liability evenly between employers and employees.[67] The wage tax provided an easy way to identify labor income because wages represent labor "being exchanged in an employer-employee setting."[68] Likewise, the payroll tax withholding system made eligibility and benefit record keeping administratively convenient[69] and made the tax "relatively easy to implement and enforce."[70]

Incorporating self-employed individuals into Social Security required a new taxation system because self-employed people, by definition, did not receive wages or have an employer with whom to share contribution responsibilities.[71] Further, covering the self-employed presented administrative difficulties because the FICA withholding system could not be replicated in the self-employment context.[72] Additionally, self-employed earnings did not have the same "labor income only" quality as wages.[73] Despite these differences, Congress desired "[t]o place the self-employed on a comparable basis with wage earners,"[74] meaning that the

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64. JOHNSON, *supra* note 38, at 186.

65. *See id.* (quoting President Roosevelt as saying, "With those taxes in there, no damn politician can ever scrap my social security program").

66. I.R.C. §§ 3101–3128 (2012).

67. *See id.* § 3101 (employee portion); *id.* § 3111 (employer portion).

68. Dilley, *supra* note 8, at 71.

69. *See id.* at 93–94 (describing the FICA system's convenience as both a revenue-collection and benefit-accrual device). Note that employers—not employees—collect FICA taxes and pay them to the government. *See* I.R.C. § 3102(a) ("The tax . . . shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid.").

70. Dilley, *supra* note 8, at 71.

71. *See id.* at 74 (describing reasons why Congress could not simply incorporate self-employed individuals into the FICA system).

72. *See id.* at 94 ("The convenience of the payroll tax withholding system is replaced by the difficulties of assessing a wage tax where there is no payroll.").

73. *See infra* notes 117–25 and accompanying text (explaining how the self-employment tax base captures both labor income and returns on capital).

74. S. REP. NO. 81-1669, at 3318 (1950).

self-employment tax system would share the FICA system's goal of taxing compensation for labor.[75]

Instinctively, Congress attempted to replicate the FICA tax model in the self-employment realm. This effort produced the self-employment tax—an income tax that Congress hoped would behave like a wage tax.[76] Section 1401 of the Internal Revenue Code[77] states that taxes "shall be imposed for each taxable year, on the self-employment income of every individual."[78] The Code imposes self-employment taxes only on "net earnings from self-employment,"[79] which § 1402 defines as

> the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed . . . which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss . . . from any trade or business carried on by a partnership of which he is a member.[80]

The section excludes several income categories from net earnings from self-employment, including: net income from rental properties (except for real estate dealers);[81] dividend and interest income (except for securities dealers);[82] and gains or losses from the sale or exchange of capital assets.[83] Because Congress wanted the self-employment tax base to parallel the FICA system's labor income base, Congress excluded these archetypal categories of capital income from the start.[84]

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75. *See* Dilley, *supra* note 8, at 74 ("Nonetheless, Congress determined that the self-employed must be taxed on a basis comparable to that of employers and employees—that is, 'on remuneration received for one's own labor.'").

76. *See id.* at 93 (characterizing the self-employment tax as an income tax that "is required to perform like a wage tax").

77. I.R.C. § 1401 (2012).

78. *Id.*

79. *See* CBO SECA REPORT, *supra* note 3, at 1 ("[T]he SECA tax base is the net business income (that is, receipts minus expenses) for self-employed workers.").

80. I.R.C. § 1402(a).

81. *Id.* § 1402(a)(1).

82. *Id.* § 1402(a)(2).

83. *Id.* § 1402(a)(3)(A)–(C).

84. *See* Dilley, *supra* note 8, at 78 ("Given the policy requirement that Social Security taxes be imposed generally on earnings from labor, as opposed to investment income, dividends and interest income are predictably excluded . . .

The first self-employment tax applied a 2.25% tax to a taxpayer's net income from self-employment.[85] This rate represented the full employee's share of the FICA tax at the time (1.5%) plus an estimate of the after-tax employer's share (0.75%).[86] Self-employed individuals paid the tax through their income tax returns and could not deduct any portion of the self-employment taxes they paid.[87]

C. Current Structure of Social Insurance Financing

The self-employment tax's structure evolved over the next thirty years, becoming more parallel to the FICA tax regime. Today, self-employed individuals pay a 15.3% SECA tax, equaling both the employer and employee portions of the FICA tax.[88] Section 164(f)[89] permits self-employed individuals to deduct one-half of their self-employment tax liability as a business expense (just as the employer's portion of the FICA tax is not included in an employee's gross income).[90] To achieve full parity with the FICA system, self-employed taxpayers may reduce their self-employment tax base by an amount equivalent to one-half of their self-employment tax liability before computing the § 164(f) deduction.[91]

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as such income is not analogous to employee wages.").

85. Berkowitz, *supra* note 60, at 25.

86. *See* Dilley, *supra* note 8, at 74 (noting that Congress intended this percentage to "represent the full employee's share plus a rough estimate of the after-tax employer's share of the tax").

87. *Id.*

88. *See* I.R.C. § 1401(a)–(b) (2012) (providing the SECA rate and describing how it is allocated); *see also* Dilley, *supra* note 8, at 74–75 (explaining that Congress revised the SECA tax structure to "require self-employed persons to pay, in effect, 'both halves' of the employer and employee shares of Social Security taxes").

89. I.R.C. § 164(f).

90. *See id.* (providing for the deduction); *see also* Dilley, *supra* note 8, at 75–76 (explaining the need for the § 164(f) and § 1402(a)(12) deductions given Congress's goal of putting the self-employed worker "in roughly the same position as an employee after income and FICA taxes are imposed on wage income" (citing H.R. REP. NO. 98-47, at 126 (1983) (Conf. Rep))).

91. *See* I.R.C. § 1402(a)(12) (providing for this deduction).

The 15.3% tax rate allocates 12.4% to the Old Age, Survivors, and Disability Insurance (OASDI) program and 2.9% to the HI program.[92] The tax's OASDI part applies only to a portion of an individual's income that is capped by statute each year and adjusted for average wage growth.[93] In 2013, the OASDI tax applied only to the first $113,700 in net earnings from self-employment.[94]

The HI portion originally had a similar earnings ceiling, but Congress removed the ceiling in 1993[95] in response to claims that the HI wage ceiling provided an advantage to higher income taxpayers. The wage cap allowed higher income taxpayers to receive Medicare coverage by contributing a much smaller percentage of their overall income than most other workers.[96] Today, the HI tax applies to *all* net earnings from self-employment, making self-employment tax liability a more significant issue for higher income taxpayers.[97]

The Health Care and Education Reconciliation Act of 2010[98] (amended by the Patient Protection and Affordable Care Act[99]) authorized two new Medicare revenue sources that took effect January 1, 2013, and also increased the tax burden for higher income taxpayers.[100] The first, codified at Internal Revenue Code

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92. *Id.* § 1401(a)–(b).

93. *See* 42 U.S.C. § 430 (2012) (providing for the adjustment of the OASDI wage base); *see also* CBO SECA REPORT, *supra* note 3, at 1 (explaining the wage cap system).

94. INTERNAL REVENUE SERV., PUB. 334, TAX GUIDE FOR SMALL BUSINESSES 4 (2012), http://www.irs.gov/pub/irs-pdf/p334.pdf.

95. *See* Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 416 (codified as amended at 19 U.S.C. § 267a and various sections of 26 U.S.C.) (eliminating the HI income ceiling).

96. *See* Dilley, *supra* note 8, at 80 (describing the rationale behind abolishing the HI earnings ceiling).

97. *See id*. at 81 (discussing highly compensated self-employed individuals' increased focus on minimizing income subject to self-employment taxes after Congress eliminated the HI wage base).

98. Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

99. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).

100. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029, 1061 (imposing the net investment income tax); Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119, 1020 (2010) (providing for the 0.9% surtax on wages and self-employment income for

§ 1411,[101] imposes a 3.8% income tax on the lesser of: a taxpayer's "net investment income" (NII) or the excess, if any, of the taxpayer's modified adjusted gross income for the taxable year over the "threshold amount."[102] Section 1411(b) sets the threshold amounts as follows: $250,000 for a married taxpayer filing a joint return; $200,000 for a single taxpayer; and $125,000 for a married taxpayer filing separately.[103] NII generally includes income from investments (such as interests and dividends) associated with a taxpayer's nonpassive activities and all income from passive activities.[104] Section 469[105] provides the framework for determining whether an activity is passive or nonpassive in relation to a taxpayer.[106]

NII does not apply to wages or self-employment income. Instead, the second new Medicare revenue source—the Medicare surtax described in § 3101[107]—increases the HI tax rate for wages and taxable self-employment income above the threshold amount from 2.9% to 3.8%.[108] The employee (or self-employed taxpayer) alone bears this 0.9% surtax.[109]

Thus, a single taxpayer having no NII but having taxable income of $250,000 from self-employment would pay 2.9% HI tax

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higher income earners).

101. I.R.C. § 1411 (2012).

102. *Id.* § 1411(a)(1)(A)–(B).

103. *Id.* § 1411(b)(1)–(3).

104. *See id.* § 1411(c)(1)–(2) (explaining the income categories subject to NII tax). The Code defines NII as the sum of the following: gross income from interest, dividends, annuities, royalties, and rents not derived from a trade or business that is passive with respect to the taxpayer; other gross income of any kind derived from a passive activity or the trade or business of trading in financial instruments or commodities; and net income from the disposition of property of a trade or business other than that used in a passive activity trade or business, less allowed deductions that are allocated to that those categories of gross income or net gain. *Id.*

105. I.R.C. § 469 (2012).

106. *See infra* Part VII.C (describing the tests set forth in § 469 for identifying passive and nonpassive income).

107. I.R.C. § 3101.

108. *See id.* § 3101(b)(1)–(2) (providing for an additional 0.9% HI tax on income over the threshold amount, increasing the HI tax rate on this income from 2.9% to 3.8%).

109. *See id.* §§ 3101–3102 (increasing only the "employee share" of the HI tax).

on the first $200,000 and 3.8% HI tax on the remaining $50,000. If the same taxpayer instead had $180,000 of taxable self-employment income and $70,000 of NII, she would pay 2.9% HI tax on the self-employment income portion ($180,000) and 3.8% NII tax on $50,000 of her NII. A single taxpayer with $250,000 of taxable self-employment income and $100,000 of NII would pay 2.9% HI tax on the first $200,000 of self-employment income, 3.8% HI tax on the remaining self-employment income ($50,000), and 3.8% NII tax on all of NII ($100,000). In tandem, the Medicare surtax and new NII tax operate to close some of the revenue gap left by the current employment and self-employment tax regimes.

III. Excluding Returns on Capital from the SECA Tax Base

Although the self-employment tax regime aims to include income from labor in its tax base and exclude income from capital, achieving this goal is not easy. While some businesses—a babysitting service, for example—can produce income from labor alone, many businesses subject to self-employment taxes generate income using both labor and capital investments.[110] For these businesses, accurately identifying and separating income derived from capital and income derived from labor with precision is difficult, if not impossible.[111]

Consider a landscaping business operated as a sole proprietorship. To generate revenue, the business requires both the owner's investment in tangible capital assets—equipment such as mowers, tools, perhaps a truck and trailer—and the owner's personal labor.[112] Likewise, as the landscaping business gains a positive reputation, the owner can reasonably attribute some income to goodwill and going concern value[113]—intangible capital assets.

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110. *Cf.* CBO SECA REPORT, *supra* note 3, at 1–2 (explaining that the self-employment tax base captures some income that represents a return on capital).

111. *See* JANE G. GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME 49 (1994) (calling it "extremely difficult—indeed, probably impossible—to separate capital income from labor income for closely held businesses where the owner may supply both capital and labor services").

112. *See id.* at 11 ("Income is the sum of wage income and capital income.").

113. *See* Treas. Reg. § 1.197-2(b)(1) (defining "goodwill" as "the value of a

Thus, the owner can appropriately characterize some portion of the business's income as a return on her investment in those capital assets. This return on capital is little different from a gain realized on appreciated real estate or interest income from a bond. Asking the landscape company owner to designate portions of each dollar earned as income derived from the business's capital assets or income derived from labor, however, would be both administratively onerous and imprecise.[114]

Therefore, the self-employment tax regime includes all net income from self-employment in the tax base unless a delineated exception excludes it.[115] Despite the Internal Revenue Code's exclusion of several capital income categories, the inclusion presumption inevitably subjects some income from capital to self-employment tax.[116]

In a September 2012 report, the CBO attempted to divide the self-employment tax base into its capital and labor components and examined various proposals to better isolate labor income in the tax base.[117] Focusing on the self-employment Hospital Insurance (SECA-HI) tax base (because it is not subject to an income ceiling[118]), the CBO estimated that approximately 40% of

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trade or business attributable to the expectancy of continued customer patronage," noting that "[t]his expectancy may be due to the name or reputation of a trade or business or any other factor"); *see also id.* §1.197-2(b)(2) (describing "going concern value" as "the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity").

114. Suppose the landscaper spends eight hours mowing a twenty-acre lot using a riding lawn mower and earns $160. How much should the landscaper attribute to the lawn mower—the capital asset—and how much should she attribute to her skill and labor in operating it? One could argue that had the landscaper invested in a walk-behind lawnmower rather than the riding mower, the prospective customer may never have even considered her bid. This scenario supports a claim that capital generated a larger portion of the income. Regardless, this type of analysis with respect to business transactions is generally impracticable.

115. *See* I.R.C. § 1402(a) (2012) (defining net income from self-employment as all self-employment income except income from categories designated in § 1402(a)(1)–(17)); *see also* Dilley, *supra* note 8, at 97 (explaining the SECA tax regime's "inclusionary" approach).

116. *See* CBO SECA REPORT, *supra* note 3, at 1–2 (noting that although Congress intended to tax the self-employed solely on remuneration for labor, the self-employment tax base "[does] not conform to that intent").

117. *See generally* CBO SECA REPORT, *supra* note 3.

118. *See supra* note 95 and accompanying text (describing the HI wage ceiling's history).

the base derives from capital.[119] Overall, 65% of capital income is subject to self-employment taxes[120] but more than half of labor income—defined as the portion of a self-employed person's income that would be subject to FICA tax if the person were employed by a corporation—is *excluded* from the SECA-HI tax base.[121]

The report explains that this distortion occurs because of the self-employment tax base's sensitivity to profitability. "[W]hen net income from all of a taxpayer's businesses is less than the labor income from those businesses, the excess labor income is excluded from the SECA tax base."[122] Profitability has no impact, however, on a corporation's FICA tax liability.[123]

Identifying ways to eliminate capital income from the self-employment tax base proves especially difficult in the context of pass-through entities because of the diversity of owner attitudes about, contributions to, and goals for these businesses.[124] Some "passive" owners view the business purely as an investment, primarily seek a financial return, and do not actively participate in the management of the business.[125] These passive owners view returns on their "business investments" and returns on other investments—such as stocks or bonds—as one and the same. Arguably, we should treat the distributive shares of these passive owners as capital income, the same as we treat dividends and interest.

Unincorporated business forms also attract "active owners"—individuals who actively participate in the management of the business, provide services, and who may or may not contribute capital.[126] These owners, of course, also seek a financial return,

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119. CBO SECA REPORT, *supra* note 3, at iv.

120. *Id.* at v.

121. *Id.* The CBO estimates that 44% of labor income is included. *Id.*

122. *Id.* at iv.

123. *See id.* at 2 (explaining this difference).

124. *See* Dilley, *supra* note 8, at 84 (positing that the self-employment tax treatment of partnership income "has relied on assumptions . . . about the relationship between the partner and the business as the indicator of whether or not wages are being paid").

125. *See* Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749, 765 (2009) (explaining that "often some owners contribute the capital necessary to start the business, while others perform the services that will hopefully make the business successful").

126. *See id.* at 765–66 (contrasting participating and nonparticipating

but their return is linked to a greater degree to their participation—their labor.[127] When these owners receive distributive shares of entity income (in lieu of, or in addition to, guaranteed payments for services), the transaction looks similar to the exchange that occurs when an employer pays wages to an employee for work. Thus, the distributive shares of these owners are perhaps better characterized as representing income from labor.

If we could easily distinguish active owners from passive owners and subject only the active owners to self-employment taxes, our self-employment tax system would better comport with Congress's intent to finance Social Security through labor income.[128] The flexible nature of unincorporated businesses, however, accommodates owners from all points on this active–passive spectrum.[129] The ability for an individual to own multiple classes of interests in a single business further complicates the problem.[130] Thus, today's unincorporated business landscape permits few bright-line rules to separate labor income from capital income for self-employment purposes.

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owners).

127. *See* Sheldon I. Banoff, Renkemeyer *Compounds the Confusion in Characterizing Limited and General Partners—Part 2*, 116 J. TAX'N 300, 317 (2012) [hereinafter Banoff, *Part 2*] (explaining that the distributive shares of service-providing owners "arise from services they performed . . . rather than as earnings that are basically of an investment nature").

128. *See* Dilley, *supra* note 8, at 82 (arguing that "all of the statutory, as well as regulatory, rules developed to deal with participants in pass-through tax entities are grounded in an attempt to discern the part of a self-employed person's income that is actually attributable to her own labor").

129. *See* Sheldon I. Banoff, Renkemeyer *Compounds the Confusion in Characterizing Limited and General Partners–Part 1*, 115 J. TAX'N 306, 313 (2011) [hereinafter Banoff, *Part 1*] ("It is now often difficult to distinguish between active owners of the business and passive investors.").

130. *See, e.g.*, UNIF. LTD. P'SHIP ACT § 113 (2001) (permitting a person to hold both a general partner and a limited partner interest in the same partnership).

IV. I.R.C. § 1402(a)(13): The Limited Partner Exclusion

A. The Limited Partner Exclusion Generally

The limited partner exclusion contained in Internal Revenue Code § 1402(a)(13) represents one attempt by Congress to establish a bright-line rule segregating labor income from capital income for self-employment tax purposes. This controversial provision[131] permits individuals classified as "limited partners" to exclude the distributive share of partnership income from self-employment income.[132] More specifically, § 1402(a)(13) permits the exclusion of

> 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) to that partner 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[.][133]

Note that salaries and professional fees received for services actually rendered—guaranteed payments representing purely labor income—remain subject to self-employment tax.

Congress enacted this provision as part of the Social Security Amendments of 1977[134] in response to fear that individuals were establishing limited partnerships and investing as limited partners solely to gain Social Security and Medicare coverage or increase their benefit amounts—a practice considered "inconsistent with the basic principle of the social security program."[135] Prior to 1977, the self-employment tax on the

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131. *See* Dilley, *supra* note 8, at 86 ("The SECA tax treatment of LLC members continues to be the most controversial aspect of both the LLC and the SECA tax areas . . . ."); *see also* Banoff, *Part 1*, *supra* note 129, at 316 (noting that there has been "little progress in identifying the operative distinctions between 'general partners' and 'limited partners' for federal tax purposes" despite "greater stress and importance on these distinctions" due to the evolution of other tax and business laws).

132. I.R.C. § 1402(a)(13) (2012).

133. *Id.*

134. Social Security Amendments of 1977, Pub. L. No. 95-216, § 313(b), 91 Stat. 1536.

135. *See* H.R. REP. NO. 95-702 (Part I), at 40–41 (1977)

> Your committee has become increasingly concerned about

distributive shares of partnership income made no distinction between general and limited partners, enabling individuals—especially older persons "who may not have been covered under the system during their working lives"—to gain insured status not through earnings from labor but rather through passive investment income.[136]

At the time of the limited partner exclusion's adoption, the self-employment tax rate was 7.9% and applied only to the first $16,500 of net earnings from self-employment for both Social Security and Medicare.[137] This low rate existed because the earnings ceiling for the Medicare portion had not yet been abolished.[138] Consequently, at the time, taxpayers widely perceived "the value of Social Security benefits . . . to outweigh their tax cost."[139]

B. Limited Partners as a Dividing Line

Given Congress's goal of funding Medicare and Social Security through a tax on labor and considering the business

> situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.

136. Dilley, *supra* note 8, at 85; *see also* Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?*, 17 VA. TAX REV. 811, 830–31 (1998) (describing Congress's intent "to curtail the practice of investing in a limited partnership as a means for the investor to become insured for social security benefits, which congressional lawmakers found to be at odds with the fundamental purpose of the social security system").

137. Tax Found. Ctr. for Fed. Tax Policy, *Social Security and Medicare Tax Rates, Calendar Years 1937–2009*, TAX FOUND. (May 5, 2009), http://taxfoundation.org/article/social-security-and-medicare-tax-rates-calendar-years-1937-2009 (last visited Sept. 15, 2013) (on file with the Washington and Lee Law Review).

138. *See supra* note 95 (recalling that Congress abolished the HI wage ceiling in 1993).

139. Dilley, *supra* note 8, at 85.

landscape at the time, Congress's decision to draw this line between limited partners and general partners made sense. In 1977, there were two primary business entity forms: corporations and partnerships (general and limited).[140] Corporations, because they have employees, are subject to the FICA tax regime.[141] Conversely, partnerships, because of their pass-through entity tax status,[142] fall within the self-employment tax regime.[143]

Within the partnership category, a general partnership did not pose the same threat as a limited partnership regarding persons investing solely to obtain Social Security and Medicare benefits. Because general partners face unlimited personal liability for partnership obligations,[144] Congress likely thought that a prospective investor would not expose himself to such risk to obtain Social Security eligibility. Conversely, the limited partnership provided an ideal opportunity to obtain benefit eligibility through investment[145] because it featured two

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140. *But see infra* Part IV.D (discussing the emergence of new business forms in the 1980s and 1990s).

141. *See* I.R.C. § 3121(a) (2012) (noting that for FICA tax purposes, the term "wages" includes "all remuneration for employment"); *see also* Fritz, *supra* note 136, at 821 ("Employees of a C corporation (including shareholder-employees) . . . are subject to employment taxes on 100% of their wages.").

142. *See* I.R.C. § 701 ("Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."). Partnerships, unlike corporations, do not pay federal income tax as distinct entities. ARTHUR B. WILLIS, JOHN S. PENNELL & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION § 2.01 (5th ed. 1994). Instead, partnership income "passes-through" as distributive shares to the individual partners who must report the income and pay any taxes on it through their individual income tax returns. *See id.* § 2.04 ("The principal income tax characteristic of the partnership is that it is a conduit through which the various items of partnership income, gain, loss, deduction, or credit are passed to the partners unchanged and are untaxed at the partnership level.").

143. *See* I.R.C. § 1401 (defining net income from self-employment to include the "distributive share (whether or not distributed) of income or loss . . . from any trade or business carried on by a partnership of which [the taxpayer] is a member").

144. *See* REVISED UNIF. P'SHIP ACT § 306(a) (1997) ("[A]ll partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.").

145. *Cf.* Fritz, *supra* note 136, at 832 ("[A] partner who desires active involvement in the partnership's affairs and minimal exposure to the SECA tax, may hold a small portion of his or her ownership interest as a general partner and the majority of his or her ownership interest as a limited partner.").

categories of ownership interests,[146] including one that offered limited liability.[147]

At the time, "limited partner" connoted two characteristics: limited liability[148] and limited (or no) ability to participate in a partnership's management.[149] In fact, a limited partner could lose her limited liability protection by participating in control of the partnership,[150] creating a natural check on limited partners' participation levels.

Thus, a limited partner could make a financial investment in a limited partnership, perform little or no labor, enjoy limited liability, and gain eligibility for Social Security benefits.[151] This eligibility pathway created opportunities for abuse and did not align with Social Security's goals of tying benefit eligibility to work and funding benefits through a tax on labor.[152]

C. Enforcement and Interpretation Before Renkemeyer

Neither the Internal Revenue Code nor the Treasury Regulations define "limited partner."[153] Until the Tax Court

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146. *See* J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE § 18.1 (2011) (describing the two categories of limited partnership ownership interests).

147. *See* REVISED UNIF. LTD. P'SHIP ACT § 303(a) (1976) (providing that limited partners are not personally liable for partnership obligations).

148. *Id.*

149. *See* CALLISON & SULLIVAN, *supra* note 146, § 22.2 (explaining that although the Revised Uniform Limited Partnership Act (RULPA) does not prohibit limited partners from participating in management, limited partnership agreements "almost uniformly provide" that limited partners may not participate due to the potential loss of limited liability protection).

150. *See* REV. UNIF. LTD. P'SHIP ACT § 303 (1976) (explaining circumstances when a limited partner's participation may make that partner liable for the obligations of the limited partnership).

151. *See* Banoff, *Part 1*, *supra* note 129, at 337 (describing this scenario).

152. *See supra* notes 134–36 and accompanying text (noting the fundamental purposes of Social Security).

153. *See* Schwidetzky, *supra* note 125, at 788 ("Who qualifies as a limited partner is not defined in the Code or Regulations, but it appears from the legislative history and the plain language of the statute that a state law limited partner is meant."); *see also* Banoff, *Part 1*, *supra* note 129, at 317 (noting that courts likely gave "limited partner" and "general partner" their generally accepted, state law meanings because "neither the Code, the legislative history, nor prior judicial construction indicated a different definition").

decided *Renkemeyer, Campbell & Weaver LLP v. Commissioner* in 2011,[154] caselaw interpreting § 1402(a)(13) focused almost exclusively on a taxpayer's status as a general or limited partner under state law.[155]

Several taxpayers have challenged their liability for self-employment taxes, arguing that their limited participation should permit them to use the limited partner exclusion. Each time, the IRS rejected the argument that participation levels—not legal status under state law—should determine whether one qualifies for the limited partner exclusion, and each time, the reviewing court affirmed the taxpayers' self-employment tax obligations.[156]

In *Cokes v. Commissioner*,[157] the taxpayer inherited working oil and gas interests in oil fields operated by a group of oil and gas leaseholders[158] but did not personally participate in the business's management.[159] The court rejected the taxpayer's argument that her lack of control meant that she was not a partner in the venture.[160] Two years later, another oil and gas investor made a similar challenge in *Johnson v. Commissioner*.[161] The taxpayer first argued that her passive participation did not rise to the level of being engaged in a trade or business as

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154. *See infra* Part VI (discussing the case).

155. *See* Fritz, *supra* note 136, at 831–32 ("[T]he Code continues to rely . . . on local law distinctions as to an individual partner's legal status rather than on the substance of his or her actual relationship to the partnership."); *see also infra* notes 157–71 and accompanying text (discussing cases where the court relied on state law classifications to interpret § 1402(a)(13)).

156. *See, e.g.*, Cokes v. Comm'r, 91 T.C. 222, 233–36 (1988) (holding the owner of an oil field lease liable for self-employment taxes despite the owner having never personally participated in the business because state law treated the venture as a partnership).

157. 91 T.C. 222 (1988).

158. *Id.* at 225.

159. *See id.* at 228 ("Petitioner never attended a meeting of the . . . working interest owners; never voted on any matter . . . ; never obtained any oil and gas leases (except for [those inherited]); never drilled any oil wells; never supervised any water flood or secondary recovery operations; and never promoted any 'oil deals' with anyone else.").

160. *See id.* at 233 ("The question before us is whether petitioner was a member of a partnership or of a joint venture treated as a partnership, and petitioner's lack of control does not affect that question.").

161. 60 T.C.M. (CCH) 603 (1990).

required by § 1401.[162] Alternatively, the taxpayer argued that if deemed a partner, the court should recognize her as a limited partner due to her minimal participation.[163] The Tax Court rejected both of these arguments, stating, "[P]etitioner is bound by the form in which she cast her transaction. . . . [L]imited partnerships are creatures of agreement cast in the form prescribed by State law. . . . [S]he and the other working interest owners did not take the necessary steps to comply with Texas law."[164]

The state-law reliance continued in two later cases in which taxpayers acknowledged their state law general partner status yet argued that their minimal participation should qualify them for the § 1402(a)(13) exclusion. The petitioners in *Perry v. Commissioner*[165] and *Norwood v. Commissioner*[166] argued that their minimal time commitments to partnership business—six to nine hours per year in *Perry*[167] and forty-one hours per year in *Norwood*[168]—should override their general partner status for self-employment tax purposes.

Again, the Tax Court rejected these arguments in favor of state law classifications. In *Perry*, the court said, "Petitioner's personal involvement [in partnership operations] is not the critical question where . . . the income was derived from an entity taxable as a partnership."[169] Similar to *Johnson*, the *Perry* court

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162. *See id.* ("Petitioner contends that the income from her working interests is not subject to self-employment tax because the working interests are merely investments; and that her activity in connection with the working interests does not rise to the level of carrying on a trade or business.").

163. *See id.* ("[P]etitioner argues that if she is considered to be a partner in a partnership, she should be considered a limited partner due to the nature of her interest.").

164. *Id.*

165. T.C. Memo. 1994-215 (1994).

166. T.C. Memo. 2000-84 (2000).

167. *See* Perry v. Comm'r, T.C. Memo. 1994-215, at 1 (1994) (explaining that the "approximately 30 to 45 minutes each month" petitioner spends "reviewing income and expense statements and depositing checks received" constitutes his total participation in the partnership business).

168. *See* Norwood v. Comm'r, T.C. Memo. 2000-84, at 1 (2000) (explaining that petitioner's involvement in the partnership business in the tax year at issue totaled forty-one hours and consisted of "periodic walkthroughs" and consultation on "major decisions of the firm").

169. *Perry*, T.C. Memo 1994-215 at 2.

lamented that "[s]tate law requires that certain formalities be observed to create a limited partnership . . . . There is no evidence of such formalities having been observed by the owners of interests in the wells."[170]

Rejecting Norwood's position, the court matter-of-factly stated, "That petitioner spent a minimal amount of time engaged in [partnership] operations is irrelevant. . . . Petitioner's lack of participation in or control over [partnership] operations does not turn his general partnership interest into a limited partnership interest. A limited partnership must be created in the form prescribed by State law."[171]

D. Evolution of Business Organizations Since 1977

Relying on state law classifications to interpret "limited partner" made sense during the limited partner exclusion's early years because state-law-based classifications could accommodate all of the available unincorporated business ownership interest categories. In the years following the provision's enactment, however, several new unincorporated business forms emerged and gained popularity.[172] These "hybrid" entities borrowed characteristics from both the partnership form and the corporate form, leading to unpredictability in applying many areas of law, including tax law. The decades following § 1402(a)(13)'s enactment also brought changes to limited partnership law that modified the roles limited partners play in these businesses.[173] After these developments, state law classifications no longer describe all of the potential unincorporated business owners. Thus, we can attribute many of the current problems interpreting the limited partner exclusion to the proliferation of these new entities and the changes in the limited partnership form.

170. *Id.* at 3.
171. *Norwood*, T.C. Memo 2000-84 at 1.
172. *See infra* Part IV.D.1–3 (describing these new forms).
173. *See infra* Part IV.D.4 (explaining these changes).

1. The Limited Liability Company

LLCs developed in response to a need for a business form that would afford its owners limited liability but would not be subject to the double-taxation regime applied to corporations.[174] Wyoming passed the first LLC Act in 1977,[175] recognizing a business form that afforded its owners, called "members," limited liability for the company's debts and obligations and permitted all members to participate in the company's management.[176] Although Florida passed the second LLC statute—modeled after the Wyoming Act—in 1982,[177] no other state passed an LLC statute until 1990 due to uncertainty regarding LLC tax treatment and concerns about members' personal liability.[178] After the IRS issued a Revenue Ruling in 1988[179] stating that LLCs properly organized under the Wyoming Act would be treated as partnerships for tax purposes,[180] other states began authorizing LLCs.[181] The IRS's 1996 adoption of the "check-the-box" regulations[182]—which created the presumption that LLCs would be treated as partnerships unless they elected to be taxed as corporations—eliminated the uncertainty.[183] By the end of 1996, all states and the District of Columbia had enacted LLC

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174. LARRY E. RIBSTEIN & ROBERT R. KEATINGE, 1 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1.2 (2013).

175. Wyoming Limited Liability Company Act, 1977 WYO. SESS. LAWS 537 (codified at WYO. STAT. ANN. §§ 17-29-101 to -1105 (2012)).

176. *See* WYO. STAT. ANN. § 17-29-304 (providing for limited liability); *id.* § 17-29-407 (providing management rights for all members as a default).

177. Florida Limited Liability Company Act, FLA. STAT. ANN. § 608.401–.471 (Supp. 1982).

178. *See* RIBSTEIN & KEATINGE, *supra* note 174, § 1.2 (describing the reasons for the delay).

179. Rev. Rul. 88-76, 1988-2 C.B. 360.

180. *Id.* (holding that a "Wyoming limited liability company, none of whose members or designated managers are personally liable for any debts of the company" is classified for federal tax purposes as a partnership).

181. *See* RIBSTEIN & KEATINGE, *supra* note 174, § 1.2 (noting that "all of the remaining states" adopted LLC statutes after the IRS issued these regulations).

182. Treas. Reg. § 301.7701-2 to 301.7701-3 (1996).

183. *See* Banoff, *Part 1*, *supra* note 129, at 313 ("The advent of the check-the-box [r]egulations . . . effective after 1996 provided virtual certainty as to the tax treatment of domestic LLCs as partnerships (absent their election to be taxed as corporations).").

statutes.[184] Today, the LLC is the fastest growing unincorporated business form,[185] and many consider it the closely held business "entity of choice" due to its flexibility.[186]

2. The Limited Liability Partnership

LLPs emerged in response to the 1980s savings and loan crisis,[187] with Texas enacting the first LLP statute in 1991.[188] By the end of the decade, all states and the District of Columbia had enacted LLP statutes.[189] The LLP is a general partnership; state law characterizes its owners as general partners.[190] Registered LLPs differ from general partnerships, however, in that LLP partners have limited liability for partnership obligations while general partners in general or limited partnerships do not.[191] The

184. *See* RIBSTEIN & KEATINGE, *supra* note 174, § 1.2 (listing the states and their enacting legislation).

185. *See id.* § 2.1 (comparing the growth of LLCs with the growth of limited and general partnerships in the 1990s and 2000s). From 1993 to 2010, the number of LLCs grew from 17,000 to nearly 2.1 million. *Id.* Conversely, the number of general partnerships declined from 1,176,000 to 590,512. *Id.* The number of limited partnerships grew from 275,000 in 1993 to a peak of 432,550 in 2006 and has been declining since, with 374,889 registered in 2010. *Id.*

186. *See, e.g.*, Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How Those LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 459–60 (2010) (calling the LLC "undeniably the most popular form of new business entity in the United States" and noting that "the number of new LLCs formed in America in 2007 [outpaced] the number of new corporations formed by a margin of nearly two to one").

187. *See* Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1069 (1995) ("The LLP is a direct outgrowth of the collapse of real estate and energy prices in the late 1980s, and the concomitant disaster that befell Texas's banks and savings and loan associations.").

188. 1991 Tex. Gen. Laws 3234 (codified at TEX. BUS. & COM. CODE ANN. §§ 801–803, 805) (1991).

189. *See* CALLISON & SULLIVAN, *supra* note 146, § 32:1 n.3 (listing the LLP statutes for all jurisdictions).

190. *See id.* ("The limited liability partnership (LLP) is a form of general partnership, created under state general partnership laws.").

191. *Compare* REVISED UNIF. P'SHIP ACT § 306(a) (1997) (providing the default rule that "all partners are liable jointly and severally for all obligations of the partnership"), *with id.* § 306(c) ("An obligation of a partnership incurred

LLP form, popular in accounting and law firms, functions as "'peace of mind' insurance for innocent partners,"[192] protecting their personal assets from risk of negligence or malpractice by another partner "over whom [they] ha[ve] no control and quite possibly ha[ve] never met."[193]

3. The Limited Liability Limited Partnership

The limited liability limited partnership (LLLP) emerged in the late 1990s and gained sufficient popularity for inclusion in the 2001 Uniform Limited Partnership Act (ULPA).[194] Unlike the LLP, the limited partnership provides the structural basis for the LLLP form.[195] Similar to the LLP, however, all partners in an LLLP—both general and limited—have limited liability protection.[196] A limited partnership becomes an LLLP by registering with the state.[197]

4. Changes to Limited Partnerships: The "Control Rule" Fades Away

The years following the limited partner exclusion's enactment also brought changes to the limited partnership form. The relaxation and eventual abolishment of the "Control Rule,"

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while the partnership is a limited liability partnership, . . . is solely the obligation of the partnership. A partner is not personally liable . . . for such a partnership obligation solely by reason of being or so acting as a partner.").

192. Hamilton, *supra* note 187, at 1066.

193. *Id.*

194. *See* Daniel S. Kleinberger, *A User's Guide to the New Uniform Limited Partnership Act*, 37 SUFFOLK U.L. REV. 583, 619–20 (2004) (explaining that the drafters of the 2001 ULPA included the LLLP form after recognizing that a "growing number" of states had amended their limited partnership statutes to permit LLLPs).

195. CALLISON & SULLIVAN, *supra* note 146, § 32:5.

196. *See* UNIF. LTD. P'SHIP ACT § 404(c) (2001) ("An obligation of a limited partnership incurred while the limited partnership is a limited liability limited partnership . . . is solely the obligation of the limited partnership. A general partner is not personally liable . . . for such an obligation solely by reason of being or acting as a general partner.").

197. *See id.* § 201(a) (noting that a limited partnership must state in its certificate whether it is an LLLP).

which had long influenced limited partners' ability to participate in partnership business, had a particularly important impact on the limited partner exclusion problem.

Under the Control Rule's initial formulation, expressed in the 1916 ULPA,[198] a limited partner could lose her limited liability protection by "tak[ing] part in the control of the business."[199] This potential penalty deterred limited partners from taking active roles in partnership management.[200] The 1976 Revised Uniform Limited Partnership Act (RULPA),[201] eventually enacted in all but six states,[202] relaxed the Control Rule by creating a "bifurcated standard of liability" for limited partners.[203] If a limited partner "[took] part in the control of the business" but did not participate to a degree "substantially the same as the exercise of the powers of a general partner," then the limited partner could only be liable to creditors with "actual knowledge" of the limited partner's participation in control.[204] A limited partner who participated to "substantially the same" degree as a general partner remained potentially liable to all third parties transacting business with the partnership.[205]

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198. UNIF. LTD. P'SHIP ACT (1916).

199. *See id.* § 7 ("A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."). For an illustration of the 1916 ULPA Control Rule—the prevailing rule when Congress enacted § 1402(a)(13)—consider *Holzman v. de Escamilla,* 195 P.2d 833 (Cal. Dist. Ct. App. 1948). *Holzman* held two limited partners in a vegetable business liable as general partners because they exercised control of the business (evidenced by their involvement in choosing the business's crops and their ability to control partnership funds without the general partner's consent). *Id.* at 859–60.

200. *See* Joseph J. Basile, Jr., *Limited Liability for Limited Partners: An Argument for Abolition of the Control Rule*, 38 VAND. L. REV. 1199, 1201 (1985) ("[A]n obvious tension arises between the limited partners' desire to exercise control over important decisions affecting the partnership and the threat of personal liability for taking part, or participating, in the control of the business of the partnership.").

201. REV. UNIF. LTD. P'SHIP ACT (1976).

202. *See* Unif. Law Comm'n, *Enactment Status Map*, LIMITED PARTNERSHIP ACT (1976), *available at* http://uniformlaws.org/Act.aspx?title=Limited Partnership Act (last visited Sept. 15, 2013) (highlighting states that enacted the 1976 RULPA) (on file with the Washington and Lee Law Review).

203. Basile, *supra* note 200, at 1210.

204. REV. UNIF. LTD. P'SHIP ACT § 303 (1976).

205. *See* Basile, *supra* note 200, at 1211 (explaining this scenario). Basile

The 1985 RULPA revisions further limited the Control Rule's scope. These amendments provided that a limited partner who participated in the control of the business would be liable only "to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner."[206] Finally, the 2001 ULPA, adopted by eighteen states,[207] eliminated the Control Rule entirely, stating:

> An obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, *even if the limited partner participates in the management and control of the limited partnership*.[208]

Without the Control Rule to deter participation, limited partners in states adopting the 2001 ULPA today face no disincentive to participate actively in a limited partnership's management.

E. Problems Presented by New Unincorporated Entity Forms

These new forms (and the limited partnership's evolution) create problems in applying the limited partner exclusion because they violate the "fundamental assumptions" about limited partnerships that first prompted Congress to enact the exclusion.[209] The dividing line Congress believed existed between limited partners and general partners in 1977 (limited partners

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also notes that this structure prevents a limited partner from "exercis[ing] all of the powers of a general partner while avoiding any direct dealings with third parties" to retain her limited liability. *Id.* (quoting RULPA § 303 cmt.).

206. REV. UNIF. LTD. P'SHIP ACT § 303 (1985).

207. *See* Unif. Law Comm'n, *Enactment Status Map*, LIMITED PARTNERSHIP ACT (2001), http://uniformlaws.org/Act.aspx?title=Limited Partnership Act (last visited Sept. 15, 2013) (highlighting states that have enacted the 2001 ULPA) (on file with the Washington and Lee Law Review).

208. UNIF. LTD. P'SHIP ACT § 303 (2001) (emphasis added).

209. *See* John R. Marquis, *Current Status of Limited Liability Companies and the Self-Employment Income Tax*, MICH. B.J., May 1998, at 440, 441 (explaining that changes, such as the RULPA's expanded partner participation rules, "call into question the fundamental assumptions" on which Congress founded the exception).

with limited liability and limited participation on one side; general partners with unlimited liability and full participation on the other) no longer exists.[210] "Limited partner" no longer unequivocally means "passive investor."

Arguably, none of today's unincorporated business forms fit the archetypal limited partner structure that Congress relied on in 1977. LLPs and LLLPs afford both general and limited partners limited liability.[211] As a definitional matter, LLCs have neither limited partners nor general partners. All LLC members may participate in management, and all may benefit from limited liability, regardless of their level of participation.[212] Further, the LLC form can accommodate both owners who use it as a passive investment vehicle and owners who seek to conduct an active business.[213] Even the trusty limited partnership no longer fits the mold.[214]

Uncertainty for taxpayers and tax professionals and unpredictability within the self-employment tax regime has developed. Without definitive guidance from the IRS or Congress on how to apply the "old" rule to "new" businesses, taxpayers have freedom to interpret the rule for themselves. This freedom creates opportunities for taxpayers to organize their businesses in such a way as to avoid self-employment taxes entirely or to take aggressive tax positions that they would be less likely to take if clear guidance existed.[215] For example, an LLC member could argue that her limited liability entitles her to exclude her income under § 1402(a)(13) even though statutorily speaking, she does not hold a limited partner interest and her business is not a

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210. *See supra* Part IV.D.1–4 (discussing unincorporated business entity changes).

211. *See supra* note 191 and accompanying text (discussing LLPs); *see also supra* note 196 and accompanying text (providing the rule for LLLPs).

212. *See supra* Part IV.D.1 (detailing the LLC form).

213. *See* Schwidetsky, *supra* note 125, at 790 (comparing members' authority in member-managed LLCs and manager-managed LLCs).

214. *See* Marquis, *supra* note 209, at 441 (questioning whether the limited partner exclusion's assumption that limited partners in traditional limited partnerships do not participate in management has "any lingering validity").

215. *See* Dilley, *supra* note 8, at 81–82 (noting the "considerable time and effort" taxpayers and tax planners have spent "developing strategies for recasting income that might be considered self-employment earnings as passive types of income that are excluded from the [SECA tax] base").

limited partnership.[216] Accepting this argument—limited liability as a sufficient condition for the limited partner exclusion—would create a gaping hole in the self-employment tax base.[217] Conversely, a passive LLC member who prefers a more conservative stance given the dearth of guidance on the issue may choose not to claim the limited partner exclusion. This choice would likely inject capital income into the self-employment tax base, another disfavored result.

Finally, the lack of guidance leads to disparate treatment of similarly situated taxpayers across various business forms.[218] The uncertainty may even prompt a taxpayer who prefers one form to select another because it provides a more certain path to obtain the exclusion for legitimately passive owners.[219]

V. Attempts to Interpret and Apply § 1402(a)(13) in the Modern Business Context

Recognizing these issues, the Treasury Department has twice attempted to provide guidance to taxpayers on how to interpret the limited partner exclusion. Regulations proposed in 1994 dealt specifically with interpretation issues faced by LLC members;[220] the 1997 proposed regulations aimed to provide guidance to all unincorporated business entities.[221] Analyzing these proposed regulations reveals a shift in the IRS's position from reliance on state law classifications to analysis of an owner's participation in the business. This shift reflects the IRS's desire to realign the

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216. *See infra* Part VI.A (discussing *Renkemeyer*, in which the LLP partner made essentially the same argument).

217. *See* Banoff, *Part 1*, *supra* note 129, at 319–20 (finding it "troublesome" and "inappropriate" to use limited versus unlimited liability for this purpose).

218. *See* Marquis, *supra* note 209, at 441 ("Why should a limited partner who does not participate in his . . . partnership's business affairs escape [self-employment taxes] while an LLC member who chooses not to participate in . . . her LLC's affairs cannot? . . . Are they not 'functionally' the same vis-à-vis the entity (neither participates and both have limited liability)?").

219. *See id.* ("Why should business persons be forced to cho[o]se a limited partnership form over an LLC form just to avoid the possibility that one of the participants would have [net earnings from self-employment] from the LLC when he or she would not from the limited partnership?").

220. *See infra* Part V.A (discussing the 1994 proposed regulations).

221. *See infra* Part V.B (discussing the 1997 proposed regulations).

limited partner exclusion with its original purpose: to remove income from passive capital investments from the SECA tax base.

A. 1994 Proposed Treasury Regulations

The first attempt to clear some of the confusion regarding the meaning of "limited partner" came in 1994 when the IRS issued proposed regulations[222] that applied § 1402(a)(13) to LLCs classified as partnerships for federal tax purposes.[223] These regulations offered a two-part analysis—comprising the "Management Test" and "Limited Partner Equivalency Test"—for determining whether an LLC member would be considered a "limited partner" for § 1402(a)(13) purposes.[224] To pass the Management Test, an LLC member could not be a "manager"[225]—meaning she had to lack authority to make management decisions for the LLC.[226] A taxpayer could easily apply this test because LLC operating agreements typically specify whether the LLC is member-managed or manager-managed and delineate any management rights of members outside of default rules.[227]

After satisfying the Management Test, the taxpayer would then analyze her company under the two-part Limited Partner Equivalency Test. This test first asks whether the LLC could have been formed as a limited partnership rather than an LLC in

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222. Prop. Treas. Reg. § 1.1402(a)-18, 59 Fed. Reg. 67253 (Dec. 29, 1994).

223. *See generally id. See also* Timothy R. Koski, *Self-Employment Tax and Limited Liability Companies: When Are LLC Earnings Subject to Self-Employment Tax?*, TAXES, Sept. 2005, at 33, 34 (describing the proposed regulations and their purposes). Recall that the "check-the-box" regulations providing that LLCs would be treated as partnerships for tax purposes as a default were not issued until 1996. *See supra* note 182 and accompanying text (explaining the "check-the-box" regulations).

224. Koski, *supra* note 223, at 34.

225. Prop. Treas. Reg. § 1.1402(b)(1), 59 Fed. Reg. at 67254.

226. *See id.* § 1.1402(c)(2) (defining "manager" as a person who "alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed").

227. *See* REVISED UNIF. LTD. LIAB. CO. ACT § 407(a) (2006) (establishing member-management as a default rule unless the operating agreement elects manager-management).

the same jurisdiction where it was formed.[228] Next, the test asks whether the member "could have qualified as a limited partner in that limited partnership under applicable law."[229] If the taxpayer could answer both questions affirmatively, she would be treated as a limited partner for § 1402(a)(13) purposes.[230]

The proposed regulations received a "mixed response."[231] Critics expressed concern that the Limited Partner Equivalency Test's reliance on state law classifications would create possibilities for disparate treatment.[232] Because state limited partner statutes differ in the extent to which they allow limited partners to participate in management, a participating, nonmanager LLC member could satisfy the test (and benefit from the § 1402(a)(13) exclusion) if his LLC was formed in one state, but fail it (denying him the exclusion) if his LLC had been formed in another.[233]

Commentators also criticized the proposed regulations as being too complex, claiming that applying the regulations "depend[s] upon legal or factual determinations that may be difficult for taxpayers or the IRS to make with certainty."[234] Others supported a "material participation" test for LLC members, claiming that it would eliminate uncertainty and better serve the policy goal of including labor income in the self-employment tax base.[235] Other critics argued that the regulations fell short because they failed to establish a uniform test

228. Prop. Treas. Reg. § 1.1402(b)(2), 59 Fed. Reg. 67253, 67254 (Dec. 29, 1994).

229. *Id.*

230. *Id.*

231. Koski, *supra* note 223, at 34.

232. *See* Prop. Treas. Reg. § 1.1402(a)–2, 62 Fed. Reg. 1702, 1702 (Jan. 13, 1997) (describing comments received in response to the 1994 regulations that highlighted the possibility for disparate treatment between members of different LLCs with "identical rights" based solely on state limited partnership statute differences).

233. *See* Koski, *supra* note 223, at 34 (explaining the possibility for disparate treatment).

234. Prop. Treas. Reg. § 1.1402(a)–2, 62 Fed. Reg. at 1702.

235. *See id.* (noting that a material participation test would "better implement the self-employment tax goal of taxing compensation for services").

applicable to all unincorporated entities whose owners may be subject to self-employment tax.[236]

Finally, some commentators stated that the proposed regulations did not adequately address the self-employment tax treatment of taxpayers holding more than one class of ownership interest.[237] These critics claimed the proposed regulations created an "all-or-nothing" test that would prevent members who held both "limited-partner-like" and "general-partner-like" LLC interests from using § 1402(a)(13) to exclude income from their limited-partner-like interests.[238] Citing § 1402(a)(13)'s legislative history, these critics argued that this system violated Congress's intention to tax only general partners' distributive shares and demanded that the Treasury Department revise the regulations to respect the bifurcation of ownership interests.[239]

B. 1997 Proposed Treasury Regulations

Recognizing the 1994 proposed regulations' weaknesses, the Treasury Department withdrew its 1994 notice of proposed rulemaking and simultaneously proposed new regulations in January 1997.[240] The 1997 proposed regulations would apply to "all entities classified as a partnership for federal tax purposes, regardless of state law characterization of the entity."[241] According to the IRS, this uniform standard would analyze "the relationship between the partner, the partnership, and the

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236. *See id.* (preferring a "more uniform approach" to govern all unincorporated business entities).

237. *See id.* (discussing issues surrounding ownership interest bifurcation).

238. *See id.* ("The proposed regulations treated an LLC member as a limited partner with respect to his . . . 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)."); *see also* Koski, *supra* note 223, at 34 (explaining that the proposed regulations classified a partner as "either a general partner or a limited partner with respect to his entire interest in the partnership").

239. *See* Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702, 1702 (Jan. 13, 1997) (outlining these critics' legislative history-based argument that Congress intended to subject only general partnership interests to self-employment taxes).

240. *Id.*

241. *Id.* at 1703.

partnership's business"[242] rather than treat state law characterizations of partners as determinative.[243] The analysis would rely on functional tests related to the individual's participation in the business.[244] Affirming the 1994 regulation feedback, the IRS noted that the new approach would ensure that similarly situated taxpayers did not receive differing self-employment tax treatment based solely on their entity's state of formation.[245] The IRS acknowledged the need for a functional test in light of the "proliferation" of new business entities and the "evolution of state limited partnership statutes"—specifically, the extent to which some limited partners may now participate while retaining limited liability.[246]

Unlike the 1994 regulations, the 1997 regulations presumed limited partnership status for § 1402(a)(13) purposes unless the taxpayer met one of three tests.[247] The first test (the "Liability Test") denied limited partner status to individuals who had "personal liability . . . for the debts of or claims against the partnership by reason of being a partner."[248] Second, an individual with "authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized" would not retain limited partner status (the "Authority Test").[249] The final test (the "Material Participation Test") focused on the extent of an owner's participation in the business.[250] Any individual who

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242. *Id.*

243. *See id.* ("State law characterizations of an individual as a 'limited partner' or otherwise are not determinative."). This language suggests that the participation standard would apply even to an individual properly characterized as a "limited partner" under state law.

244. *See id.* at 1702 (detailing the functional tests).

245. *See id.* ("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.").

246. *Id.*

247. *Compare* Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997) ("An individual is treated as a limited partner . . . *unless* . . . ." (emphasis added)), *with* Prop. Treas. Reg. § 1.1402(a)-18, 59 Fed. Reg. 67253, 67253 (Dec. 29, 1994) ("[A] member of an LLC will be treated as a limited partner *only if* . . . ." (emphasis added)).

248. Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(i), 62 Fed. Reg. at 1704.

249. *Id.* § 1.1402(a)-2(h)(2)(ii).

250. *See id.* § 1.1402(a)-2(h)(2)(iii) (describing the test).

"participate[d] in the partnership's trade or business for more than 500 hours during the partnership's taxable year" would not be considered a limited partner.[251]

In addition, the regulations excepted "service partnerships"—defined as partnerships in which "substantially all" activities relate to the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting—from the general test.[252] "Service partners"—individuals providing services "to or on behalf of the service partnership's trade or business"[253]—could not utilize the limited partner exception, even if they satisfied the three functional tests.[254]

The 1997 proposal also addressed bifurcated ownership interests. Proposed Treasury Regulation § 1.1402(a)-2(h)(3) permits an individual who fails the functional tests (by holding a general-partner-like interest) to nonetheless exclude income related to his limited-partner-like ownership interest upon meeting two conditions.[255] First, there must be other owners of the purported limited-partnership-like class of interest who satisfy the functional tests set forth in Proposed Regulation § 1.1402(a)-2(h)(2).[256] Second, the individual owning the bifurcated interest must have rights and obligations with respect to the limited-partner-like ownership interest that are identical to the rights and obligations of the other limited partners.[257]

The regulations also provide a path to limited partner status for individuals who hold only one class of ownership interest and fail only the Material Participation Test.[258] Similar to the bifurcated-interest holder, the "material participant" can still

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251. *Id.*

252. *Id.* § 1.1402(a)-2(h)(6)(iii).

253. Prop. Treas. Reg. § 1.1402(a)-2(h)(6)(ii), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). The regulations provide that a partner is not considered a "service partner" if he "only provides a de minimis amount of services to or on behalf of the partnership." *Id.* § 1.1402(a)-2(h)(6)(ii).

254. *See id.* § 1.1402(a)-2(h)(5) (clarifying that a service partner in a service partnership may not gain limited partner status under any of the three tests in §1.1402(a)-2(h)(2)–(4)).

255. *See id.* § 1.1402(a)-2(h)(3) (noting this possibility).

256. *See id.* § 1.1402(a)-2(h)(3)(i) (explaining this condition).

257. *See id.* § 1.1402(a)-2(h)(3)(ii) (explaining this condition).

258. *See id.* § 1.1402(a)-2(h)(4) (describing the exclusion).

receive limited partner treatment if the entity has other owners who satisfy the functional tests and the material participant's rights and obligations are identical to the rights of the limited partners.[259] In this scenario, the taxpayer would pay self-employment tax on guaranteed payments for her services but could exclude her distributive share under § 1402(a)(13).[260] Together, these two rules work toward the goal of excluding "amounts that are demonstrably returns on capital invested in the partnership" rather than labor.[261]

The 1997 proposed regulations were "severely criticized by Congress."[262] Influenced by prominent business leaders such as Steve Forbes, who called the proposed regulations "a major tax increase by a stealth regulatory decree,"[263] Congress feared that the proposed regulations—specifically the Material Participation Test—would adversely affect small businesses.[264] Discussion of the proposed regulations through popular media channels like The Rush Limbaugh Show allowed the proposed regulations to gain "wide notoriety among the rank and file voters, most of whom it is safe to say had little understanding of their real effect, intended or otherwise."[265]

Practitioners noted that the regulations generated criticism because they "appeared to change the statutory rules so as to make more limited partners subject to the self-employment tax.[266] In reality, these practitioners said, the regulations were more

259. *See id.* § 1.1402(a)-2(h)(4)(i)–(ii) (explaining this exception).

260. *See* Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702, 1703 (Jan. 13, 1997) (describing how the proposed regulation would apply to this scenario).

261. *Id.*

262. Koski, *supra* note 223, at 36.

263. William H. Byrnes & Robert Bloink, *Tax Court Revives Partnership Self Employment Tax Debate*, ADVISORONE (Mar. 25, 2011), http://www.thinkadvisor.com/2011/03/25/tax-court-revives-partnership-self-employment-tax?t=legal-compliance&page=2 (last visited Sept. 15, 2013) (on file with the Washington and Lee Law Review).

264. *See id.* (stating that twenty-three senators expressed specific concerns about the Material Participation Test's impact on small business owners' tax bills).

265. Marquis, *supra* note 209, at 442.

266. *Id.*

likely to significantly *decrease* the number of LLC members subject to the tax.[267]

C. Regulatory Moratorium and Aftermath

Nonetheless, the criticism led Congress to enact a one-year moratorium on the rulemaking process for the proposed regulations.[268] Despite the moratorium's limited duration, the IRS, having many other regulatory and enforcement priorities, likely interpreted the moratorium as an order not to raise the issue again—not in one year, and perhaps not ever. A nonbinding resolution[269] passed in conjunction with the moratorium supports this interpretation. The resolution expressed the Senate's concern that the proposed regulations "exceed[] the regulatory authority of the Treasury Department and would effectively change the law administratively without congressional action."[270] Further, the resolution stated, "It is the sense of the Senate that . . . Congress, *not the Department of the Treasury or the Internal Revenue Service*, should determine the tax law governing self-employment income for limited partners."[271]

In the fifteen years since the moratorium expired, neither Congress nor the IRS has restarted the rulemaking process.[272] Taxpayers and tax professionals remain uncertain regarding the proposed regulations' importance because the IRS never officially withdrew them.[273] While some scholars and practitioners have

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267. *See id.* (predicting that the regulations would have subjected fewer LLC members to self-employment tax).

268. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 (codified in scattered sections of 26 U.S.C.) (providing that "no temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998").

269. 143 CONG. REC. S6693–96 (daily ed. June 27, 1997).

270. *Id.* at S6694.

271. *Id.* (emphasis added).

272. *See* Koski, *supra* note 223, at 36 (noting that the regulations have not been finalized and neither Congress nor the IRS has issued any other definitive guidance).

273. *See, e.g.*, ROBERT R. KEATINGE, NEW CURRENTS IN SELF-EMPLOYMENT TAXES AND THE DEFINITION OF "LIMITED PARTNER": PLANNING IN LIGHT OF *RENKEMEYER*, THE MEDICARE TAX CHANGES WHICH TAKE EFFECT IN 2013, AND

called the proposed regulations "the most definitive guidance available" on how to apply § 1402(a)(13) to LLCs,[274] others believe the regulations have limited value. For these critics, such as Robert Keatinge, the only truly "definitive guidance" on how to apply § 1402(a)(13) to LLCs comes from private letter rulings issued in the mid-1990s, which held that the provision did not exclude LLC members' distributive shares from self-employment taxes.[275] Keatinge believes these rulings suggest that all LLC members, "*regardless* of the level of their activities or their authority or participation in management" are subject to self-employment tax."[276] Despite his reluctance to rely on the proposed regulations in advising clients, Keatinge acknowledges that according to Treasury Regulation § 1.6662-4(d)(3)(iii),[277] the IRS considers proposed regulations "substantial authority" for purposes of avoiding accuracy-related penalties related to tax underpayment.[278]

After the moratorium's political uproar faded, the limited partner exclusion problem received little publicity until 2011, when an aggressive tax position taken by three lawyers from Kansas gave the Tax Court the perfect opportunity to suggest a new interpretation of § 1402(a)(13).

OTHER DEVELOPMENTS 12–13 (2012) (discussing the effect of regulations that have been issued but have not yet become effective) (on file with the Washington and Lee Law Review).

274. Koski, *supra* note 223, at 34.

275. *See* I.R.S. Priv. Ltr. Rul. 9525058 (June 23, 1995) (ruling that distributive shares of members of a prospective law firm LLC would be subject to self-employment tax); I.R.S. Priv. Ltr. Rul. 9452024 (Dec. 30, 1994) (explaining that although an LLC is classified as a partnership for federal tax purposes, an LLC is not a limited partnership and its members are not limited partners, meaning that self-employment taxes apply to LLC distributive shares); I.R.S. Priv. Ltr. Rul. 9432018 (Aug. 12, 1994) (determining that LLC members' distributive shares did not qualify for exclusion from self-employment tax based on § 1402(a)(13)); *see also* KEATINGE, *supra* note 273, at 13 (explaining his interpretation of the private letter rulings).

276. KEATINGE, *supra* note 273, at 13.

277. Treas. Reg. § 1.6662-4(d)(3)(iii) (2003).

278. *See id.* (listing "proposed, temporary and final regulations" construing provisions of the Internal Revenue Code as sources of substantial authority related to accuracy-related penalties for understating tax liabilities); *see also* KEATINGE, *supra* note 273, at 13 (acknowledging the regulations' value for this purpose).

VI. Renkemeyer *Renews Attention on the Issue*

The February 2011 ruling in *Renkemeyer, Campbell & Weaver LLP v. Commissioner* renewed attention on the limited partner exclusion not only because the case demonstrates the potential for abuse created by the provision's uncertainty, but also because the Tax Court departed from precedent in abandoning strict reliance on state law classifications to instead rely on the legislative intent behind § 1402(a)(13) and apply a participation-focused standard.

A. Analyzing Renkemeyer

The petitioner-taxpayer, Troy Renkemeyer, performed legal services as a partner in a law firm organized as an LLP under Kansas law.[279] For tax year 2004, the LLP had four partners: Renkemeyer, two other attorneys (Todd Campbell and Tracy Weaver), and RCGW Investment Management, an S corporation owned by RCGW Investment Management Inc., Employee Stock Ownership Plan and Trust (ESOP).[280] The ESOP listed Renkemeyer, Weaver, and Campbell as its beneficiaries.[281] Each attorney partner held a one-third capital interest and a 30% profits and loss interest in the firm.[282] The S corporation held the remaining 10% profits and loss interest.[283] In 2004, despite deriving 99% of its net business income from fees for legal services rendered by Renkemeyer, Campbell, and Weaver, the law firm allocated 87.557% of its net business income to the S corporation.[284] In tax year 2005, the law firm reorganized, eliminating the S corporation partner and assigning each of the remaining three partners—Renkemeyer, Campbell, and

279. Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C., 137, 138 (2011).
280. *Id.* at 138–39.
281. *Id.* at 139.
282. *Id.*
283. *Id.*
284. *Id.* at 139–40.

Weaver—a 1% "General Managing Partner Interest" and a 32% "Investing Partner Interest."[285]

None of the attorney partners included their partnership distributive shares on their tax returns as net income from self-employment.[286] Instead, Renkemeyer argued that the IRS should characterize his interest (along with Campbell's and Weaver's) as a limited partner interest, which would exclude the income from net earnings from self-employment under I.R.C. § 1402(a)(13).[287] Renkemeyer said that his interest deserved this classification because the law firm's organizational documents "designated [the attorney-partners' interests] as limited partnership interests" and because the partners "enjoy[ed] limited liability pursuant to Kansas law."[288]

The Tax Court rejected Renkemeyer's argument.[289] The court began its analysis by contrasting the state-law-based characteristics of LLPs and limited partnerships. It emphasized that unlike an LLP, a limited partnership features two distinct classes of partnership interests: general partners and limited partners.[290] The court also noted that in traditional limited partnerships, limited partners lack management power and have limited liability for partnership debts so long as they do not actively participate in the control of the partnership (mentioning RULPA 1976).[291] Accordingly, these characteristics beget the inference that "the interest of a limited partner in a limited partnership is generally akin to that of a *passive investor*."[292] In contrast, general partnerships registered under state law as LLPs—such as Renkemeyer's firm—allow partners to enjoy both limited liability and management powers.[293]

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285. *Id.* at 141–42.

286. *Id.* at 139.

287. *Id.* at 147.

288. *Id.* Note that Mr. Renkemeyer did not argue that his LLP was a limited partnership under Kansas law.

289. *Id.*

290. *Id.*

291. *Id.*

292. *Id.* at 147–48.

293. *See id.* at 148 ("In essence, an L.L.P. is a general partnership that affords a form of limited liability protection for all its partners by filing a statement of qualification with the appropriate state authorities.").

The court then reviewed potential authority to aid in interpreting § 1402(a)(13). After noting that Congress enacted the limited partner exclusion "at a time (1977) before entities such as L.L.P.s were contemplated,"[294] the court considered the 1994 and 1997 Proposed Treasury Regulations, which aimed to provide guidance on applying § 1402(a)(13) to modern business forms.[295] Because Congress and the Treasury Department had never enacted the regulations nor issued any other "pronouncements with respect to the definition of a limited partner for purposes of the self-employment tax,"[296] the court said it was "left to interpret the statute without elaboration."[297]

Accepting that "limited partner" has no accepted "ordinary meaning," the court focused on the limited partner exclusion's legislative history to discern a definition.[298] Specifically, the court focused on the limited partner exclusion's original purpose: to prevent individuals from using earnings that are "basically of an investment nature" to receive Social Security benefits.[299] From this analysis, the court concluded that "[t]he 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 . . . from liability for self-employment taxes."[300] The Tax Court then held that the petitioners owed self-employment taxes on their distributive shares because the earnings arose from the legal services the taxpayers had performed.[301]

294. *Id.*

295. *See id.* at 148–49 (describing the 1997 proposed regulations and the negative response that led to Congress issuing the 1998 moratorium).

296. *Id.* at 149.

297. *Id.*

298. *See id.* ("It is a well-established rule of construction that if a statute does not define a term, the term is to be given its ordinary meaning. . . . And we look to the legislative history to ascertain Congress' intent if the statutory purpose is obscured by ambiguity.").

299. *See id.* at 149–50 ("'The bill would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. This is to exclude for coverage purposes certain earnings which are basically of an investment nature.'" (quoting H. R. REP. NO. 95-702, at 11 (1977))).

300. *Id.* at 150.

301. *See id.* (finding it "clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment" but instead

B. Responses to Renkemeyer

A general consensus exists that the Tax Court correctly ruled against the petitioner in *Renkemeyer*[302] in light of the taxpayer's "aggressive"—to some, "ridiculous"[303]—position.[304] Although the result—requiring Renkemeyer to pay self-employment taxes on the disputed income—did not surprise many in the tax community, the court's analysis in reaching that result and its perceived implications have elicited a spirited response.

First, critics note that the *Renkemeyer* facts provided an easy path for the court to rule for the government—one that did not require inquiry into legislative history. Because Kansas law recognized Renkemeyer and associates as "general partners," the court needed only to cite the three previous cases (*Johnson*, *Perry*, and *Norwood*),[305] which found state law partner status determinative.[306] The opinion did not mention those cases, nor did it directly declare that Renkemeyer, Campbell, and Weaver were "not limited partners" (even though it mentioned that

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"arose from legal services [the partners]performed on behalf of the law firm" and were thus subject to self-employment taxes).

302. *See* Banoff, *Part 2*, *supra* note 127, at 300 (calling the decision "correct"); Thomas R. Wechter, *Are Service Performing Partners of LPs, LLPs or LLCs Exempt From Self-Employment Taxes?*, AICPA TAX INSIDER, Aug. 2011, *available at* http://www.duanemorris.com/articles/are_service_performing_partners_exempt_from_self_employment_taxes_4183.html (calling the decision "not a surprise") (on file with the Washington and Lee Law Review).

303. *See* Shamik Trivedi, Renkemeyer *Facts Limit Decision's Scope, Practitioners Say*, 133 TAX NOTES 555, 555 (Oct. 31, 2011) (quoting one practitioner who said, "Seeing law firm partners trying to assert that they're not subject to self-employment taxes seems ridiculous").

304. *See* Susan L. Megaard & Michael M. Megaard, *Reducing Self-Employment Taxes on Owners of LLPs and LLCs After* Renkemeyer, PRAC. TAX STRATEGIES, Aug. 2011, at 52, 52 (calling the result "not surprising").

305. *See supra* Part IV.C (discussing these cases).

306. *See* Amy S. Elliott, *Tax Court Decision Could Reignite Debate over Partnerships and Employment Taxes*, 130 TAX NOTES 1244, 1245 (Mar. 14, 2011) ("By issuing [the opinion] the court opted not to do what other courts ruling in this area have done, which was simply to hold that [petitioners] were not limited partners of a state law [limited partnership] and therefore could not take advantage of the [limited partner exclusion]."); *see also* Banoff, *Part 2, supra* note 127, at 304–05 (criticizing the court's assertion that "limited partner" is a term "obscured by ambiguity" given that courts have found the term's ordinary meaning "clear, under state law").

Kansas law recognizes their LLP as a general partnership).[307] Also, Sheldon I. Banoff noted that neither party's brief discussed § 1402(a)(13)'s legislative history "[n]or gave any mention of it as being relevant" to resolving the issue.[308]

Critics have also expressed frustration that *Renkemeyer* creates more uncertainty in an area of law already quite uncertain.[309] Some practitioners fear that the Tax Court's emphasis on participation to determine limited partner status implies that even those individuals classified as limited partners by state law—the exact group the limited partner exclusion originally targeted—may forfeit the exclusion through substantial participation.[310]

Finally, observers claim *Renkemeyer* has created further confusion regarding the applicability of the 1997 proposed regulations to LLP partners and LLC members.[311] Some say the court's "functional" approach—looking at whether a partner actively participated in the partnership and whether income from the partnership is predominantly "of an investment nature"—closely resembles the 1997 proposed regulations' functional approach.[312] Though the *Renkemeyer* Court mentioned the proposed regulations, it did not directly affirm or dismiss them,

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307. *See* Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C. 137, 147–48 (2011) (explaining that LLPs retain their general partnership status under Kansas law); *see also* Wechter, *supra* note 302 (criticizing the decision for taking a functional approach "[r]ather than merely holding that a partner in a state law LLP is not a [limited partner] for purposes of self-employment tax").

308. Banoff, *Part 2*, *supra* note 127, at 305.

309. *See, e.g.*, Elliott, *supra* note 306, at 1246 ("[P]ractitioners said that the level of uncertainty in this area is so great that not only would it be common to find inconsistent positions taken within an accounting firm, but also it wouldn't be surprising to find inconsistent positions taken by the same accountant.").

310. *See* KEATINGE, *supra* note 273, at 15 ("If, as the opinion suggests, 'limited partner' must be understood by reference to whether the partner performs services, the opinion might be broadly read to hold that a limited partner under state law who performs services is not a 'limited partner' for purposes of IRC § 1402(a)(13).").

311. *See id.* at 15 ("The opinion calls into question whether the 1997 Regulations have application to partners in LLPs and members in LLCs."); *see also* Banoff, *Part 2*, *supra* note 127, at 308–15 (describing these concerns).

312. *See* Wechter, *supra* note 302 (comparing the court's approach to the 1997 proposed regulations).

stating only that without *final* regulations, the court felt obliged "to interpret the statute without elaboration."[313]

Following the *Renkemeyer* decision, IRS special counsel Dianna Miosi, while speaking at the May 2011 American Bar Association Section of Taxation meeting, stated that taxpayers "can rely" on the 1997 proposed regulations.[314] Still, conservative practitioners argue that "can" rely does not mean "should" rely and question advising clients based on Miosi's comments.[315]

VII. The Next-Best Solution: Adopt a Material Participation Standard

The reactions to *Renkemeyer* illustrate the tax community's desire for definitive interpretive guidance. The case exemplifies the inconsistency—and in some instances, abuse—that § 1402(a)(13)'s current murky status has produced. The ideal solution to this problem would be a standard that required each business owner to characterize each dollar of her distributive share of entity income as either a return on labor or a return on capital. Only the portion categorized as a return on labor would be subject to self-employment taxes. This solution, as previously discussed, is not practicable because it is so difficult, and perhaps impossible, to make such characterizations with precision.[316] Further, such a system would rely heavily on a taxpayer's subjective judgment. This subjectivity invites inconsistent application and increases opportunities for abuse or aggressive positions like the one taken in *Renkemeyer*.[317]

The next-best approach is to adopt a material participation standard to determine whether an unincorporated business

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313. Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C. 137, 148–49 (2011).

314. *See* Monte A. Jackel, *Has Politics Trumped Policy?*, 131 TAX NOTES 745, 746 (May 16, 2011) (describing Miosi's statements).

315. *See id.* at 746–47 ("[B]eing oral advice and not in compliance with the governing revenue procedure on written advice to taxpayers, [Miosi's statement] is not binding on the government.").

316. *See supra* note 111 and accompanying text (discussing these practical difficulties).

317. *See supra* note 9 (describing how reliance on self-classification of income can lead to abuse or inconsistent designations).

owner's distributive share of entity income belongs in the self-employment tax base. A material participation standard, such as the one outlined in the 1997 proposed Treasury regulations,[318] provides only the "next-best" solution because it suffers from the same flaw that plagues the limited partner exclusion as it exists today: it is all or nothing.[319] A distributive share is treated as though it is entirely a return on labor and taxed, or treated as though it is entirely a return on capital and excluded. In reality, distributive shares of entity income belonging to service-providing partners often represent returns on both capital and labor.

The limited partner exclusion in its current state creates a SECA tax base that underincludes income from labor in favor of ensuring that returns on capital are excluded. A material participation standard would do the opposite. Under such a standard, the SECA tax base would capture more labor income, but it would also likely capture some returns on capital. With an all-or-nothing standard, the question becomes one of policy: which flavor of income should the self-employment tax regime favor?

To answer this question, one need only look to the historical foundations of the self-employment tax. Designed to complement the FICA payroll tax regime and implemented to fund Social Security—a benefit program designed to replace income from labor through contributions from laborers—the SECA tax regime has always been labor-oriented. Given the SECA tax base's tendency to severely underinclude labor income,[320] revising the limited partner exclusion standard to favor including labor income seems most appropriate.

Notwithstanding its limitations, a material participation standard provides the soundest approach to achieving the limited partner exclusion's policy goals in today's business landscape. First, a material participation standard would address the salient

318. *See supra* Part V.B (describing the regulations and offering 500 hours per year as a threshold for "material participation").

319. *See* Fritz, *supra* note 136, at 850 (explaining that the 1997 proposed regulations' material participation test would "adopt an all-or-nothing approach," categorizing income "without any mechanism for distinguishing between remuneration for services rendered and return on capital invested").

320. *See supra* notes 117–23 and accompanying text (explaining that less than half of labor income is included in the SECA tax base).

criticisms of the current law regarding inconsistent treatment of similarly situated taxpayers. Such a standard would end reliance on state law classifications, increasing fairness and consistency at both the entity choice and ownership classification levels. Next, a material participation standard would enhance consistency with related provisions in the Internal Revenue Code. Lastly, such a standard would best align with the original policy goals behind the Social Security program and the exclusion's enactment.

A. Increasing Fairness

A material participation standard can be applied consistently to all unincorporated business forms, placing owners who "functionally resemble" each other in relation to their entities on similar footing.[321] As a result, prospective businesses would feel less pressure to select one entity form over another to obtain favorable self-employment tax treatment for some or all of their owners.[322] Further, this change would eliminate the inconsistent treatment of owners of the same entity type who have identical rights but happened to register their businesses in different states.[323] If state law labels no longer matter, then "general partners" and "limited partners" with equal participation levels will receive equal tax treatment.[324]

This change could even increase fairness within a single business. Consider a nonparticipating investor who agreed to be designated a "general partner" solely to fulfill creditors' demands that *someone* within the business have unlimited liability. The current standard penalizes this owner with self-employment tax liability but permits his co-owners—participating to the same extent but designated and recognized as "limited partners" by state law—to escape the tax. A material participation standard

321. Marquis, *supra* note 209, at 444.

322. *See supra* note 218 and accompanying text (lamenting these situations).

323. *See* Fritz, *supra* note 136, at 859–60 (advocating for adoption of a uniform standard that does not rely on state law classifications).

324. *See* Banoff, *Part 1*, *supra* note 129, at 321 (noting that if activity is the standard, "the labels 'general partner' and 'limited partner' become meaningless").

would eliminate the penalty on the general partner for making that business-advancing choice.

Further, a material participation standard tied to number of hours worked would be easier for tax practitioners and lay taxpayers to understand and more feasible to apply.[325] This standard would require the same type of recordkeeping that many individuals already undertake to comply with passive activity provisions.[326] Moreover, in general, such a standard would not require the taxpayer to make complicated legal judgments to comply.[327] These factors enhance both the likelihood of compliance and the perceived fairness of the standard.

B. Enhancing Consistency Within the Internal Revenue Code

A material participation standard for § 1402(a)(13) would also align well with other relevant Code provisions such as § 469[328]—providing passive activity loss rules[329]—and the new § 1411[330]—implementing the Net Investment Income tax.[331] A term's meaning need not be consistent across the entire Internal Revenue Code; often inconsistent meanings can actually better serve the policy goals Congress envisioned in enacting various provisions.[332] Consistency between the definition of "limited partner" in § 469 and § 1402(a)(13), however, makes sense given the two provisions' similar legislative origins and policy objectives.[333] Because § 1411 relies on the § 469 interpretation of

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325. *See id.* (mentioning that a "minimum hours per year" test would be an "easy-to-administer, simple, bright-line test").

326. *See infra* Part VII.B.1 (discussing the § 469 passive activity rules and the provision's material participation standard).

327. *See* Prop. Treas. Reg. § 1.1402(a)–2, 62 Fed. Reg. 1702, 1702 (Jan. 13, 1997) (recognizing concerns about standards that depend on "legal or factual determinations that may be difficult for taxpayers or the IRS to make with certainty").

328. I.R.C. § 469 (2012).

329. *Id.*

330. *Id.* § 1411.

331. *Id.*

332. *See* Banoff, *Part 1*, *supra* note 129, at 326 (explaining that the IRS often assigns meanings provision-by-provision and noting this practice's benefits).

333. *See* Stewart Karlinsky, *Self-Employment Taxes and PALs: The Case of*

"limited partner,"[334] consistency between § 1402(a)(13) and § 469 will also improve application of § 1411.

1. Section 469

Section 469 imposes limitations on the deductibility of losses. The provision and related regulations characterize activities as either "active" or "passive" using a material participation standard.[335] The provision defines "material participation" as "involve[ment] in the operations of the activity on a basis which is regular, continuous, and substantial."[336]

Generally, the provision permits taxpayers to deduct passive activity losses only from other passive activity income.[337] In contrast, a taxpayer may use "active" activity losses to immediately offset taxable income from *any* other source, including salary, wages, interest, or other capital gains.[338] Losses disallowed under § 469 carry over to future years and may be deducted when passive income exists or the taxpayer disposes of the activity that generated the passive activity loss.[339]

LLCs, 132 TAX NOTES 1391, 1392, 1394 (Sept. 26, 2011) (asserting that "much of the Social Security tax gap could be closed" through consistent interpretation of "limited partner" in § 469 and § 1402 and suggesting that the IRS could use the "fairly long-settled" passive activity loss regulations "to differentiate passive earnings from active earnings for net self-employment purposes"); *see also* N.Y. STATE BAR ASSOC. TAX SECTION, REP. 1247, COMMENTS ON THE APPLICATION OF EMPLOYMENT TAXES TO PARTNERS AND ON THE INTERACTION OF THE SECTION 1401 TAX WITH THE NEW SECTION 1411 12 (2011) [hereinafter NYSBA REPORT], http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1247report.pdf (recommending adoption of a material participation standard "analogous to that of *Section 469*").

334. *See* I.R.C. § 1411(b)(2)(A) (2012) ("A trade or business is described in this paragraph if such trade or business is a passive activity (*within the meaning of section 469*) with respect to the taxpayer . . . ." (emphasis added)).

335. *See id.* § 469(c)(1) (defining "passive activity" as "conduct of a trade or business" in which the taxpayer "does not materially participate").

336. *Id.* § 469(h)(1)(A)–(C).

337. *See id.* § 469(a)–(c) (explaining the general passive activity loss rule).

338. *See id.* § 165 (describing the general, nonpassive loss deduction rules); *see also* Orly Sulami, *Good News in a Bad Economy: Service Acquiesces on Pro-Taxpayer Application of Passive Activity Loss Rules to Limited Liability Companies*, 65 TAX LAW. 81, 81–82 (2011) (explaining the rule).

339. *See* I.R.C. § 469(b), (f), (g) (providing the carryover rules).

Before Congress enacted these rules in 1986, taxpayers attempted to reduce their tax liability by investing in businesses that generated tax losses in excess of the investors' economic outlays.[340] These tax-loss-generating investments—often limited partnerships—served to shelter income from other sources.[341] To eliminate these tax shelters, Congress drew a dividing line (similar to the one in § 1402(a)(13)) between "limited partners" and "general partners" by creating a presumption under § 469(h)(2) that limited partners do not materially participate (making their income per se passive).[342] In creating this presumption, Congress assumed that limited partners held limited liability and lacked the ability to participate in a partnership's management—the same assumptions about limited partners that colored § 1402(a)(13)'s enactment.[343]

General partners may satisfy the material participation standard through one of seven tests outlined in Temporary Treasury Regulation § 1.469-5T(a).[344] Limited partners who do not also hold general partner interests may use only three of these tests—considered more stringent—to overcome the passivity presumption.[345] These three tests ask whether the taxpayer participated in the activity for more than 500 hours during the taxable year;[346] whether he materially participated for

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340. *See* Sulami, *supra* note 338, at 83 (describing § 469's history).

341. *See id.* (explaining Congress's concern with "taxpayers' ability to significantly reduce their tax liability with deductions and credits attributable to losses that lacked economic reality").

342. I.R.C. § 469(h)(2) (2012); *see also* Sulami, *supra* note 338, at 85 (explaining the limited partner presumption).

343. *See* Banoff, *Part 1*, *supra* note 129, at 333 (describing the role these assumptions played in Congress's § 469 decision-making process); Garnett v. Comm'r, 132 T.C. 368, 380 (2009) (describing "the legislative belief that statutory constraints on a limited partner's ability to participate in the partnership's business justified a presumption that a limited partner generally does not materially participate").

344. *See* Temp. Treas. Reg. § 1.469-5T(a) (1996) (listing the material participation tests).

345. *See* Sulami, *supra* note 338, at 85–86 (explaining the tests and noting that a limited partner may not use the "more lenient material participation tests" available to general partners and other taxpayers).

346. Temp. Treas. Reg. § 1.469-5T(a)(1).

any five of the preceding ten taxable years;[347] or whether the activity is a "personal service activity."[348]

The evolution of unincorporated business entities has created problems interpreting § 469 similar to those created in the context of § 1402(a)(13), especially with regard to LLCs. Without clear statutory or regulatory guidance, most LLC owners (and the IRS) have taken the position that the limited partner presumption applies to LLCs.[349] Several recent cases, however, clarified that LLC ownership interests are not presumptively passive limited partnership interests.[350] In response, the Treasury Department proposed regulations in 2011[351] that remove the passivity presumption for LLC interests. These regulations "eliminate . . . reliance on limited liability" to distinguish between limited and general partners for § 469(h)(2) purposes, looking instead to the taxpayer's right to participate in management of the entity.[352]

If § 1402(a)(13) employed the material participation standard employed by § 469, taxpayers would lose the incentive to advance

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347. Temp. Treas. Reg. § 1.469-5T(a)(5).

348. Temp. Treas. Reg. § 1.469-5T(a)(6). "Personal service activity" is defined as an activity that "involves the performance of personal services in (1) [t]he fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (2) [a]ny other trade or business in which capital is not a material income-producing factor." Temp. Treas. Reg. § 1.469-5T(d).

349. *See* Sulami, *supra* note 338, at 86–88 (describing early applications of § 469 to LLCs).

350. *See* Newell v. Comm'r, 99 T.C.M. (CCH) 1107, at *5–6 (2010) (holding that a managing LLC member functioned as the "substantial equivalent" of a general partner, making it inappropriate to apply the limited partner passivity presumption); Garnett v. Comm'r, 132 T.C. 368, 380 (2009) (concluding that LLC and LLP interest owners may use the seven material participation tests available to "general partners" for passive activity loss purposes and refusing to use an owner's limited liability as a determinative factor); Thompson v. United States, 87 Fed. Cl. 728, 734–39 (2009) (reading § 469(h)(2) literally to conclude that the passive presumption applies only to taxpayers recognized by state law as limited partners).

351. Prop. Treas. Reg. § 1.469-5(e)(3)(i), 76 Fed. Reg. 72,875 (Nov. 28, 2011).

352. *See id.* at 72,877 ("Recognizing that the original presumptions regarding [a limited partner's participation] are no longer valid . . . and . . . recognizing the emergence of LLCs, the proposed regulations eliminate the current regulations' reliance on limited liability . . . and instead adopt an approach that relies on [a] partner's right to participate in the management . . . .").

a literal interpretation of § 469 (that is, that the heightened participation standards imposed on limited partners are applied only to taxpayers who are limited partners in a state law limited partnership) while at the same time advancing a nonliteral, functional interpretation of § 1402(a)(13) (that is, that the limited partner exclusion should extend beyond those having the formal title of limited partner to any owner who has limited liability under state law).[353] If the IRS finalizes the § 469 proposed regulations without issuing corresponding interpretive guidance for § 1402(a)(13), an LLC member could easily have "the best of both worlds"—the ability to deduct LLC losses against nonpassive income under the passive activity loss rules and avoid self-employment taxes through the limited partner exclusion.[354] As Orly Sulami notes, "[t]his ability of investors to inconsistently apply and benefit from the definition of 'limited partner' comes at the expense of the Treasury Department."[355] Sulami also argues that the IRS, "aware of the detrimental effects of recent case law" issued the proposed passive loss regulations to "help mitigate this dichotomy."[356]

2. Section 1411

The material participation standard would also dovetail nicely with the new Affordable Care Act taxes. As Part II.C explains, § 1411 imposes the NII tax on income from "passive" activities, as defined under § 469. Consistency between § 469 and § 1402 would enable taxpayers to better identify income subject to the NII and nonpassive income instead subject to the Medicare surtax. A consistent standard would also prevent taxpayers from calling income "active" to avoid the NII tax but "limited partner-like" to avoid the self-employment tax.[357] As Keatinge notes,

353. *See* Karlinsky, *supra* note 333, at 1392 (asking whether "what's good for the goose (the taxpayer avoiding Section 469)" is "also good for the gander (the taxpayer subject to the self-employment tax under Section 1402)").

354. Sulami, *supra* note 338, at 106–07.

355. *Id.* at 107.

356. *Id.*

357. *See* NYSBA REPORT, *supra* note 333, at 21 (arguing that a material participation standard "would generally require taxpayers to take consistent tax positions with respect to Section 1402, the passive loss rules of Section 469, and

current limited partner exclusion law would allow a limited partner who actively participates in a business but has no wages or net earnings from self-employment to avoid the Affordable Care Act taxes.[358]

C. Supporting the Self-Employment Tax Regime's Original Goals

Most important, a material participation standard best aligns with Social Security's founding policy premises. Specifically, a material participation standard will promote universal participation and will further Congress's desire to impose self-employment taxes on labor income.

As Part II.A explains, Social Security's framers knew the program would not generate enough revenue to meet its future obligations unless all workers participated. While the framers analogized the program to a pension to increase popular support, they founded Social Security on the belief that the nation as a whole had a duty to create some measure of economic security for its citizens.[359] Universal participation in Social Security—and universal participation in its financing system—thus serves both practical and ideological ends.[360] Section 1402(a)(13)'s current structure permits some taxpayers to opt out of the self-employment tax regime through entity choice—an option that is inconsistent with the system's universal participation goal. A material participation standard, however, would promote this historical objective by eliminating opportunities for unincorporated business owners to make such an election.

Next, a material participation standard would promote the policy goal of funding Social Security through taxes on labor

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the new Section 1411 Tax").

358. *See* KEATINGE, *supra* note 273, at 19 (positing this scenario).

359. *See* President Franklin D. Roosevelt, Message to the Congress Reviewing the Broad Objectives and Accomplishments of the Administration (June 8, 1934), *in* 3 PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 287, 288 (1938) ("We are compelled to employ the active interest of the Nation as a whole through government in order to encourage a greater security for each individual who composes it.").

360. *See* JOSEPH A. PECHMAN, FEDERAL TAX POLICY 215 (1983) (describing how universal participation eliminates the incentive for a worker to shift occupations to avoid paying employment or self-employment taxes).

income. When Congress enacted § 1402(a)(13), it stated that it wanted to exclude earnings that were basically "of an investment nature" from the self-employment tax base.[361] Congress used limited partners' limited liability and limited participation as signs of "investment" income. Because those signs no longer accurately point to investment income, new indicators are needed to identify investment income.

Considering that limited liability is a policy choice, designed to *promote investment*,[362] a person's limited liability says nothing about whether income from the associated activity *is* an investment. Thus, limited liability should not be the new "signal."

A person's participation in managerial decisions, however, can transform passive "investments" into active ventures. Participation, like labor, connotes activity, not passivity.[363] If limited partners in 1977 participated in management to the extent that limited partners in 2013 may participate, it is doubtful that Congress would have used limited partnership status as a labor–capital dividing line. By reframing the interpretive standard to focus solely on participation, the self-employment tax base can better fulfill Congress's original intent to include labor income in the SECA tax base and exclude "investment" income.

D. Criticisms of a Material Participation Standard

As stated, those who reject a material participation standard because it lacks a mechanism for a materially participating owner to exclude a portion of his earnings as return on capital present a valid concern. Critics of the material participation standard suggest that a partner's distributive share of entity income always represents a return on invested capital.[364]

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361. H. R. REP. NO. 95-702(I), at 11 (1977).

362. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 90–97 (1985) (noting that "[l]imited liability . . . has long been explained as a benefit bestowed on investors by the state" and explaining how limited liability encourages investment).

363. *See* BLACK'S LAW DICTIONARY 1229 (9th ed. 2009) (defining "participation" as the "*act* of taking part in something") (emphasis added).

364. *See* Fritz, *supra* note 136, at 850–51 (equating distributive shares of partnership income with returns on capital).

But this claim discounts that capital investments in unincorporated businesses do not generate financial returns in a vacuum. When a business owner adds labor to capital to generate income, at least a portion of that income is a return on labor.[365] Capital investments—such as buying a building to house a new store or purchasing a piece of manufacturing equipment to add a product line—obviously generate returns by increasing a business's value. But labor turns the building into a profit-generating store or calibrates that equipment to manufacture the new product. If a business owner paid an employee to set up a new store or set up that machinery, the FICA tax regime would capture the employee's income and impose employment taxes.

Under the current interpretation of the limited partner exclusion, a business owner could perform the identical labor as that employee, refuse all guaranteed payments for those services, and keep her return on that labor out of the SECA tax base. This inconsistent result contributes to the porous nature of the self-employment tax base.[366] The only way to address these "leaks" is to adopt a standard that is more inclusive of labor income, even if it means increasing the likelihood that some returns on capital will be subject to SECA taxes. Given Congress's willingness to subject returns on capital to an income tax of a percentage equal to the Medicare tax through the new NII tax,[367] a system that is slightly overinclusive of capital should not cause great concern.

VIII. Conclusion

Recognizing its limitations, a material participation standard provides the soundest and most feasible approach to achieving the limited partner exclusion's policy goals in today's business landscape. The question remains, however, as to *who* should

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365. *See supra* Part III (explaining how the landscape business owner combines his labor with capital investments to generate income); *see also* JOINT COMM. ON TAXATION, ADDITIONAL OPTIONS TO IMPROVE TAX COMPLIANCE 33–34 (Aug. 3, 2006) ("[L]abor income is also earned by employee-owners of passthrough entities conducting capital-intensive businesses.").

366. *See supra* notes 117–23 and accompanying text (noting that the current SECA tax base captures less than 50% of labor income).

367. *See supra* notes 101–06 and accompanying text (describing the 3.8% net investment income tax and its application to returns on capital).

adopt the standard and *how* it should be adopted. Perhaps the simplest solution would be for the Treasury Department to initiate the rulemaking process for regulations similar to the ones proposed in 1997. But, given Congress's response to the 1997 regulations, especially the Senate resolution expressing concern that the Treasury had "exceeded its authority," the Treasury Department is unlikely to issue regulations without congressional prompting.

A better solution would be for Congress to incorporate the material participation standard in the statute by eliminating the reference to "limited partner" and replacing it with participation-focused language. This solution, however, would likely evoke the same backlash from the business community that doomed the 1997 regulations. That backlash, coupled with the difficulty of enacting any revenue increase in today's political climate, makes congressional action less likely. Moreover, the fact that Congress has known about the lost self-employment revenue since the mid-1990s but has not acted to address the problem might demonstrate that Congress is comfortable with lax enforcement of the provision.

Ad hoc judicial interpretation offers the final means to adopt a material participation standard. The Tax Court's laudable decision in *Renkemeyer* has created an opportunity for other courts to reject reliance on state law classifications and interpret the limited partner exclusion to serve the provision's original policy goal. Changing the law through case-by-case judicial interpretation will not provide taxpayers with guidance as efficiently or effectively as a legislative resolution, but it may be the only feasible way to achieve change in this area.