

Tax Alert

September 10, 2014

IRS Internal Memorandum Advises That Self-Employment Tax Applies to Profits From an Investment Manager

On September 5, 2014, the Office of Chief Counsel, Internal Revenue Service (IRS) released an internal generic legal advice memorandum (available [here](#)) advising an IRS field agent that the statutorily provided “limited partner” exception to self-employment tax is not available to members of an investment management company whose income was from fees for managing investment funds. The memorandum’s analysis is contrary to the long-standing common interpretation and generally accepted practice that investment managers are eligible for the statutory exception.

The IRS’s position in the memorandum is not entirely unexpected, given recent increased scrutiny of the self-employment tax issue in connection with management company audits. There have also been at least two cases in the past few years, both of which were cited and discussed at length in the memorandum, which invalidated the use of the limited partner exception by active partners in a professional services limited liability partnership (LLP) and limited liability company (LLC), respectively.¹

If the limited partner exception were no longer available, then all profits of a management company attributable to limited partners would be subject to the 3.8 percent Medicare portion of the self-employment tax.²

The management company described in the memorandum was operating as a state law limited liability company during the years at issue. As released, the memorandum does not specifically address the applicability of its conclusion to investment professionals who are state law “limited partners” of a management company that is a state law “limited partnership,” which is the organizational form more commonly used by investment professionals seeking to avail themselves of the limited partner exception.

Nonetheless, the memorandum’s analysis clearly suggests that it would apply to investment professionals who are limited partners in a management company limited partnership,³ and dismisses as irrelevant common features such as the making of guaranteed payments to, and the investment of capital by,

¹ *Renkemeyer, Campbell, and Weaver LLP v. Comm’r*, 136 T.C. 137 (2011) (law firm LLP); *Riether v. United States*, 919 F. Supp. 2d 1140 (D. N.M. 2012) (physician LLC).

² This would generally include deferred compensation that is due to be included in income in 2017.

³ In this regard, the memorandum states: “[The members] perform extensive investment and operational management services for the partnership in their capacity as [members] (i.e., acting in the manner of self-employed persons) The income earned by [the members] through [the management company] is not income which is basically of an investment nature of the sort that Congress sought to exclude from self-employment tax when it enacted the [limited partner exception]. Accordingly, [the members] are not limited partners within the meaning of [the limited partner exception] and they are subject to self-employment tax on their distributive shares of [the management company’s] income[.]”

investment professional partners.⁴ If its conclusion were successfully applied to limited partnerships, the memorandum would push the boundaries of the existing case law that it cites beyond that of LLPs and LLCs to state law limited partnerships—thereby impairing a common management company planning technique.⁵

However, the two-page “Case Development, Hazards and Other Considerations” section of the memorandum is redacted, and the unredacted portion of the memorandum does not address the significant arguments supporting the use of the limited partner exception within the context of a management company limited partnership. Therefore, at this point, it is unknown how the IRS assesses the strength of the memorandum’s conclusion and whether it believes that its position is strong.

It is also unknown whether the memorandum addressed the prior congressional moratorium on Treasury regulations regarding the limited partner exception, or whether the memorandum considered recent Obama administration and Congressional proposals that would provide a partial exemption from self-employment tax to active partners in a partnership.⁶ Most importantly, it is unknown whether eligibility for the limited partner exception will become a key issue on audit that the IRS is unlikely to settle on terms favorable to taxpayers.

Generic legal advice memorandums are issued to IRS field agents who have questions as to points of law during the course of an audit and specifically may not be used or cited as precedent, and do not constitute definitive authority. Taxpayers generally are not required to disclose on their tax returns that they are taking a position contrary to a memorandum in order to avoid penalties.

The conclusion of this memorandum is nonetheless significant for many management companies and their investment professionals and we will continue to monitor developments with respect to the memorandum and IRS audit practice on this issue. Depending on future developments, investment

⁴ It is important to note that the memorandum also seemingly considered features that are employed by taxpayers in order to reduce the risks associated with claiming the limited partner exception. It is common practice for limited partners in limited partnerships claiming the limited partner exception to receive a portion of their earnings as guaranteed payments and to invest capital in the partnership. However, the memorandum dismisses in its analysis as irrelevant the fact that investment professionals pay self-employment taxes on at least a portion of their earnings from the management company, through guaranteed payments, or have more than nominal capital invested in the management company.

⁵ We note that the memorandum does not address the applicability of the 3.8 percent net investment income (NII) tax, which would presumably continue to not apply to active partners in a management company. Similarly, nothing in the memorandum indicates that its conclusion would apply to a general partner that receives a carried interest under a typical incentive compensation arrangement.

⁶ More specifically, the memorandum’s positions are contrary to amendments to the limited partner exception proposed by both the Obama administration and the House Committee on Ways and Means. These proposals would effectively provide a partial exemption to self-employment tax to partners in partnerships, including management companies. For example, the Ways and Means proposal would treat distributive shares of income to limited partners who materially participate in the trade or business of the partnership as partially subject to self-employment tax (to the extent of 70 percent thereof) and partially exempt from self-employment tax (to the extent of 30 percent thereof). The proposals, as described, imply that—as a matter of tax policy and current law—limited partners in limited partnerships, including management companies, should not be subject to self-employment tax on at least a portion of the management fees earned by a partnership because their income is in part a return on invested capital.

professionals seeking to limit exposure to self-employment taxes ultimately may consider using an S corporation⁷ (to which the memorandum suggests that a different and potentially more favorable legal analysis could apply) as the management company, among other potential alternatives, in order to distinguish themselves from the facts of the memorandum. However, it is too early to determine how this issue will develop and whether and when investment professionals—particularly those conducting their management business through a limited partnership—would be served to reconsider their current management company structure.

⁷ We note that use of an S corporation as a management company has certain disadvantages which would warrant careful consideration.

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