Limited Partners of Investment Managers may be Subject to Self-Employment Taxes

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The Internal Revenue Service recently placed its crosshairs on limited partners of investment management companies by ruling that an LLC's limited partners may be subject to self-employment (SE) tax. In early September, the IRS released guidance* that discussed whether distributions to an investment management company LLC's limited partners are exempt from SE tax when the partners provide services to the LLC.

The guidance describes a typical hedge fund management company LLC that is treated as a partnership for federal tax purposes. The company manages investments for a group of funds and receives a quarterly fee from the funds for its services. The fees are based on the assets under management at each fund and the company treats them as ordinary income. Partners at the company perform a variety of services, including investment management, trading, accounting and tax services. The company pays them wages that are reported on a W-2 as well as a distributive share of company income. The company classifies all of the partners as "limited partners" with respect to the distributive share payments. Under the tax rules, the distributive share of a limited partner can be excluded from the SE tax calculation unless it is determined that the payment constituted remuneration for services.

The management company argued to the IRS that its partners received reasonable compensation that was reported on W-2s, and that they qualified for the exemption from SE tax on their distributive share of management company income. The IRS countered that the intent of the exemption was to exclude distributions that are of an investment nature and in this case, the payments were compensation to the partners. This, among other reasons, led the IRS to conclude that the distributive share paid by the management company LLC to the limited partners was subject to SE tax.

The IRS has ventured into this area before with mixed results. In 1997, Treasury proposed regulations that attempted to define the circumstances in which a limited partner would qualify for exemption from the SE tax. After significant public uproar over the proposals, the Senate responded by urging Treasury to withdraw the proposed regulations and passing a nonbinding resolution declaring the definition of a limited partner was outside the scope of Treasury's authority. Additionally, Congress imposed a 12-month moratorium on Treasury's authority to issue guidance on the definition of a limited partner. Treasury and the IRS have since been silent on the issue.

It's important to note that the Service's guidance from this year applies only to the examination of one specific management company LLC. It is not considered binding on other taxpayers, but it does provide insight into the Service's reasoning in similar situations. And it does beg the bigger question, is the IRS reviving the battle from 1997 and will the IRS once again target limited partners in all types of partnerships? The guidance in this case does not address limited partners in a traditional limited partnership, so the answer to this question remains to be seen.

If you would like more information on self-employment tax or any other tax issues, please feel free to contact us.

* Chief Counsel Advice 201436049