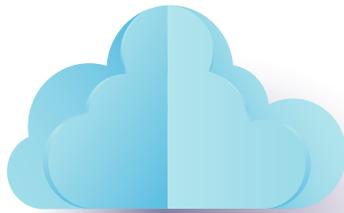


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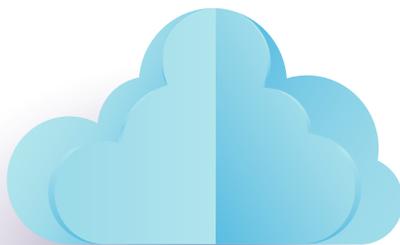
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Limited Partners and Self-Employment Tax

As tax professionals, we are often given Schedule K-1 forms by our clients in order to report their income and/or losses from their investments in pass-through organizations. **How involved are we, or should we be, in making sure these Schedule K-1 forms are correct?**



Keith A. Espinoza, EA



One issue that frequently comes up in my practice is the treatment of self-employment tax for partners and the exceptions in the Internal Revenue Code (IRC) for limited partners.

In general, an individual partner's distributive share of income is subject to self-employment tax (SE).ⁱ Internal Revenue Code §1402(a)(1)-(17) provides several exceptions, however.ⁱⁱ

Specifically, IRC §1402(a)(13) provides an exclusion from SE tax for limited partners.ⁱⁱⁱ

There are proposed regulations but no final regulations on this exclusion, so we must look at statutory language, legislative history, case history, and finally, the proposed regulations themselves.^{iv} Afterwards, we will examine how taxpayer returns can be greatly affected by these exceptions.

Our discussion includes all entities treated as partnerships for federal income tax purposes. This includes joint ventures, limited liability companies (LLCs), limited liability partnerships (LLPs), limited partnerships (LPs), and limited liability limited partnerships (LLLLPs).^v

Legislative History

The Federal Insurance Contributions Act of 1935 (FICA) imposed a tax on wages to fund the Social Security program.^{vi} Generally, employers and employees pay employment taxes also known as FICA tax. However, partners in a partnership cannot be employees of the partnership but are considered self-employed.^{vii}

The Self-Employment Contributions Act of 1954 (SECA) brought partners, sole proprietors, and other self-employed individuals into the Social Security system.^{vii}

Under SECA, individual partners who work in the partnership's business are subject to SECA tax on their "net earnings from self-employment." Internal Revenue Code §1402(b) says that the term "self-employment income" means "the net earnings from self-employment."^{ix} For our purposes, SECA tax, FICA tax, and SE tax are one and the same.

Internal Revenue Code §1402(a)(13) states: "There shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments..."^x

The statute, however, does not define a "limited partner." There are no final regulations under IRC §1402(a)(13). As a result, application of this code section depends on the statute, legislative history, and case law.

The Revised Uniform Limited Partnership Act of 1976 provided that a limited partner would lose his limited liability protection if, in addition to the exercise of his rights and powers as a limited partner, he takes part in controlling the business.^{xi}

Congress' intent at the time was to carve out an exclusion from SE tax for earnings which were of an investment nature. The exclusion, however, was not extended to guaranteed payments received for services actually performed by the limited partner.^{xii}

Individual partners who do not have limited liability are subject to SE tax regardless of their participation in the partnership business or the capital-intensive nature of the partnership business. The material participation rules under IRC §469 have no bearing on whether an individual partner may be subject to SE tax.^{xiii}

Court Cases

The leading court case on whether IRC §1402(a)(13) applies is *Renkemeyer*.^{xiv} *Renkemeyer*, Campbell, and Weaver, LLP, was a law firm organized as an LLP. The partners were three attorneys and an S corporation which controlled their employee stock ownership plan (ESOP). After reallocating income away from the ESOP partner and to the attorney partners, the court decided that the attorneys were not limited partners and, therefore, their income was subject to SE tax.

The court noted that the intent of IRC §1402(a)(13) was to ensure that individuals who merely invested in a partnership but did not actively participate would not receive credits towards their Social Security coverage. It also noted that the legislative history did not support a holding that Congress intended to exclude partners who performed services for the partnership from liability for SE tax.

Several other cases rely on the *Renkemeyer* opinion. The tax court in *Hardy v. Commissioner* determined that Dr. Hardy was a limited partner because he was a mere investor in the LLC.^{xv} The LLC operated a surgical facility. Its revenue came from fees for use of the facility and not fees for personal services. Dr. Hardy did not manage or administer the surgical facility. Therefore, his share of income was not subject to SE tax.

In *Castigliola v. Commissioner*, the tax court relied on facts similar to *Renkemeyer*.^{xvi} The taxpayers were partners in an LLC law firm working full-time, providing services and overseeing employees. The LLC paid each partner

substantial guaranteed payments. The taxpayers claimed that only the guaranteed payments, and not their full distributive share of net earnings, were subject to SE tax. The court applied *Renkemeyer* in determining the taxpayers were not limited partners for purposes of IRC §1402(a)(13).

In *Reither v. United States*, the court again cited the *Renkemeyer* analysis and ruled in favor of the government.^{xvii} Dr. Reither was a radiologist. He and his spouse were members of a medical diagnostic imaging LLC. The LLC improperly paid wages to the doctor and his wife and they did not subject their distributive shares of LLC income to SE tax. The taxpayers argued that because they were given a Form W-2 in addition to their Schedule K-1 form, they were not self-employed but, rather, were employees of the partnership; and they argued that income from the LLC was unearned income not subject to SE tax.

The court ruled that Dr. and Mrs. Reither did not resemble limited partners and, therefore, their distributive share of income was subject to SE tax. It stated: "The only relevant exception applies to limited partners. For a taxpayer treated as a general partner, however, the distributive share of partnership income is subject to SE tax irrespective of the nature of his membership." The court cited *Renkemeyer* in determining that the taxpayers were not "limited partners."

The Office of Chief Counsel issued two opinions on IRC §1402(a)(13). In Chief Counsel Advice (CCA) 201436049, an LLC involved in investment management and other professional services had previously been an S corporation.^{xviii} The members asserted that they could use the reasonable compensation rules they had been under as an S corporation, and that they were limited partners for purposes of the §1402(a)(13) exception.

The CCA concluded that the LLC cannot change the character of its partners distributive shares by mislabeling

them as wages. And since they were not a corporation, the reasonable compensation rules did not apply. It also concluded that the partners were not limited partners within the meaning of IRC §1402(a)(13).

In CCA 201640014, a franchisee in a chain of restaurants operated as an LLC.^{xix} He directed the operations, had authority to enter into contracts, hire and fire employees, and hire professionals. The LLC paid the franchisee guaranteed payments. He argued that only the guaranteed payments (and not the full distributive share of net earnings) were subject to SE tax. The CCA pointed out that the IRC §1402(a)(13) exclusion for limited partners is not determined by a reasonable return on capital, the presence of guaranteed payments, or the capital-intensive nature of the business. The exclusion is based on the status of the partner not the source of the income.

Proposed Regulations

In 1997, the Treasury Department and the Internal Revenue Service (IRS) promulgated proposed regulations defining “limited partner” for IRC §1402(a)(13) purposes.^{xx} The proposed regulations applied to all partnerships including LLCs. These regulations provide a three-prong test to determine when a partner should be treated as a limited partner. An individual is generally treated as a limited partner unless he:

1. Has personal liability for the debts or claims against the partnership due to being a partner; or
2. Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or
3. Participates in the partnership’s trades or businesses for more than 500 hours during the partnership’s taxable year.

The proposed regulations permit an individual who is not a limited partner to exclude a portion of his distributive share if he holds more than one class of interest in the partnership.^{xxi} It also allows him or her to bifurcate his or

her distributive share by disregarding guaranteed payments for services. In each case, however, such bifurcation of interests is permitted only to the extent the individual’s distributive share is identical to the distributive share of partners who qualify as limited partners under the proposed regulation (without regard to the bifurcation rules) and who own a substantial, continuing interest in the partnership.

If, substantially, all of the partnership’s activities are in the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business is not considered a limited partner, regardless of what the other rules may provide.^{xxii}

The 1997 proposed regulations are not final, meaning they are not law. Instead, the applicable analysis is the statutory language, legislative history,

and case law. Taxpayers, however, may rely on them. This means the IRS will respect a partner’s status as a limited partner if he or she qualifies under these proposed regulations.^{xxiii}

Client Planning and Examples

It is common to see incorrect Schedule K-1 forms. The most common error is to see an entry for self-employment earnings on line 14 (box A) when there should be a zero. The obvious effect is the client will incorrectly be charged SE tax. It is up to the preparer to correctly identify whether or not the client holds a limited partner interest under the IRC §1402(a)(13) rules. It is easy to attach Form 8275, *Disclosure Statement*, or Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request*, to the return and disclose the error made on the Schedule K-1 form.

This Schedule K-1 form is similar to ones presented by clients who have been sold limited partnership interests

Example Schedule K-1 form

The interesting thing to note here is that the line 14 (box A) amount is blank.

ent earnings (loss)
0.
one activity for

The statute does not define a “limited partner.” There are no final regulations under IRC §1402(a)(13). As a result, application of this code section depends on the statute, legislative history, and case law.

by their employer. In this case, the client is a highly salaried employee of that partnership (which, of course, is itself not a correct method of paying a partner). The interesting thing to note here is that the line 14 (box A) amount is blank. The Schedule K-1 forms have footnotes attached which say:

“The Schedule K-1s have not reported the ordinary income from the trade or business activities (line 1 and line 4) as self-employment income on line 14(A) for the limited partners. Each partner has been advised to consult with their

tax advisor regarding the treatment of their ordinary trade or business income from their partnership interest for self-employment tax purposes.”

This is what the client’s Form 1040 looks like if the return is done with the exact information on the Schedule K-1 form. Note that there is no SE tax, and the client receives a refund of \$4,245.

After having read this article, a tax professional can easily determine that the client does not hold a limited partner interest for purposes of self-employment

income under the proposed Treasury Regulations 1.1402(a)-2(h).^{xvii} Not only does the taxpayer work in the business, but he is a service partner in a service business. Line 14(A) of the Schedule K-1 form should be \$19,193. This is the sum of ordinary business income on line 1 of \$9,829 plus the guaranteed payments on the line 4(A) of \$9,364.

This is how the client’s Form 1040 changes after making the proper corrections. The client now has a refund of \$6,899, which is \$2,654 higher than the return with no SE tax! The important points to note here are:

1. Since the employee is highly compensated on his Form W-2 (which, again, is an issue that needs to be addressed with the partnership), he is over the ceiling on the Social Security portion of his SE tax, and only pays \$514 on the Medicare portion.
2. Since he is self-employed, and his guaranteed payments represent health

Example Form 1040

Form 1040 (2020) Page 2

16	Tax (see instructions). Check if any from Forms: 1 <input type="checkbox"/> 8814 2 <input type="checkbox"/> 4972 3 <input type="checkbox"/>	16	47,548.
17	Amount from Schedule 2, line 3	17	
18	Add lines 16 and 17	18	47,548.
19	Child tax credit or credit for other dependents	19	
20	Amount from Schedule 3, line 7	20	11.
21	Add lines 19 and 20	21	11.
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	47,537.
23	Other taxes, including self-employment tax, from Schedule 2, line 10	23	129.
24	Add lines 22 and 23. This is your total tax	24	47,666.
25	Federal income tax withheld from:		
a	Form(s) W-2	25a	51,811.
b	Form(s) 1099	25b	
c	Other forms (see instructions)	25c	100.
d	Add lines 25a through 25c	25d	51,911.
26	2020 estimated tax payments and amount applied from 2019 return	26	
27	Earned income credit (EIC)	27	
28	Additional child tax credit. Attach Schedule 8812	28	
29	American opportunity credit from Form 8863, line 8	29	
30	Recovery rebate credit. See instructions	30	
31	Amount from Schedule 3, line 13	31	
32	Add lines 27 through 31. These are your total other payments and refundable credits	32	
33	Add lines 25d, 26, and 32. These are your total payments	33	51,911.
34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you overpaid	34	4,245.
35a	Amount of line 34 you want refunded to you. If Form 8888 is attached, check here	35a	4,245.
b	Routing number	c	Type <input checked="" type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
36	Amount of line 34 you want applied to your 2021 estimated tax	36	
37	Subtract line 33 from line 24. This is the amount you owe now	37	
38	Estimated tax penalty (see instructions)	38	
39	Add lines 37 and 38. This is the amount you owe for 2020. See Schedule 3, line 12e, and its instructions for details.	39	
40	Do you want to allow another person to discuss this return with the IRS? See instructions		
41	Designee name <input checked="" type="checkbox"/> Yes, Complete below <input type="checkbox"/> No		
42	Designee name: KEITH A. ESTINOZA, EA Phone no: (303) 238-5300		
43	Your signature: KEITH A. ESTINOZA, EA Date: 08/26/2021	43	51,911.
44	Your occupation: IT DIRECTOR	44	4,245.
45	Spouse's signature: If a joint return, both must sign. Date: 08/26/2021	45a	4,245.
46	Spouse's occupation: IT DIRECTOR		
47	Preparer's name: KEITH A. ESTINOZA, EA Date: 08/26/2021		
48	Preparer's signature: [Signature] Date: 08/26/2021		
49	Preparer's name: AUTOMATED ACCOUNTING SERVICES, INC. Phone no: (303) 238-5300		
50	Preparer's address: 1600 CARR STREET, LARKWOOD, CO 80214 Fax no: (303) 238-5300		

Note that there is no SE tax, and the client receives a refund of \$4,245.

Example Form 1040

Form 1040 (2020) Page 2

16	Tax (see instructions). Check if any from Forms: 1 <input type="checkbox"/> 8814 2 <input type="checkbox"/> 4972 3 <input type="checkbox"/>	16	44,220.
17	Amount from Schedule 2, line 3	17	
18	Add lines 16 and 17	18	44,220.
19	Child tax credit or credit for other dependents	19	
20	Amount from Schedule 3, line 7	20	11.
21	Add lines 19 and 20	21	11.
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	44,209.
23	Other taxes, including self-employment tax, from Schedule 2, line 10	23	807.
24	Add lines 22 and 23. This is your total tax	24	45,016.
25	Federal income tax withheld from:		
a	Form(s) W-2	25a	51,811.
b	Form(s) 1099	25b	
c	Other forms (see instructions)	25c	100.
d	Add lines 25a through 25c	25d	51,911.
26	2020 estimated tax payments and amount applied from 2019 return	26	
27	Earned income credit (EIC)	27	
28	Additional child tax credit. Attach Schedule 8812	28	
29	American opportunity credit from Form 8863, line 8	29	
30	Recovery rebate credit. See instructions	30	
31	Amount from Schedule 3, line 13	31	
32	Add lines 27 through 31. These are your total other payments and refundable credits	32	
33	Add lines 25d, 26, and 32. These are your total payments	33	51,911.
34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you overpaid	34	6,899.
35a	Amount of line 34 you want refunded to you. If Form 8888 is attached, check here	35a	6,899.
b	Routing number	c	Type <input checked="" type="checkbox"/> Checking <input type="checkbox"/> Savings
d	Account number		
36	Amount of line 34 you want applied to your 2021 estimated tax	36	
37	Subtract line 33 from line 24. This is the amount you owe now	37	
38	Estimated tax penalty (see instructions)	38	
39	Add lines 37 and 38. This is the amount you owe for 2020. See Schedule 3, line 12e, and its instructions for details.	39	
40	Do you want to allow another person to discuss this return with the IRS? See instructions		
41	Designee name <input checked="" type="checkbox"/> Yes, Complete below <input type="checkbox"/> No		
42	Designee name: KEITH A. ESTINOZA, EA Phone no: (303) 238-5300		
43	Your signature: KEITH A. ESTINOZA, EA Date: 08/26/2021	43	51,911.
44	Your occupation: IT DIRECTOR	44	6,899.
45	Spouse's signature: If a joint return, both must sign. Date: 08/26/2021	45a	6,899.
46	Spouse's occupation: IT DIRECTOR		
47	Preparer's name: KEITH A. ESTINOZA, EA Date: 08/26/2021		
48	Preparer's signature: [Signature] Date: 08/26/2021		
49	Preparer's name: AUTOMATED ACCOUNTING SERVICES, INC. Phone no: (303) 238-5300		
50	Preparer's address: 1600 CARR STREET, LARKWOOD, CO 80214 Fax no: (303) 238-5300		

The client now has a refund of \$6,899, which is \$2,654 higher than the return with no SE tax!

insurance premiums paid by the partnership on his behalf, he can take the self-employed health insurance deduction of \$9,364 as an adjustment to income on the Schedule 1 form.

3. The value of the deduction for self-employed health insurance far outweighs the SE tax from the correct treatment of the income on the Schedule K-1 form.

Summary

Being able to correctly identify when and if your clients hold limited partnership interests for purposes of SE tax is crucial in preparing an accurate return. This is especially true for those who prepare partnership returns on Form 1065 but is equally important for those who prepare returns of individuals who receive Schedule K-1 forms from partnerships.

The three-prong test found in Prop. Treas. Reg 1.1402(a)-2(h) is not complex and is easily applied. Multiple items on the client's returns may be affected and large variations in the bottom line can result if reported incorrectly. As a reminder, it is essential to disclose

any differences between Form 1040 positions and the Schedule K-1 on either Form 8082 or Form 8275.

ⁱ IRC §1402(a)
ⁱⁱ IRC §1402(a)(1)-(17)
ⁱⁱⁱ IRC §1402(a)(13)
^{iv} Prop. Treas. Reg. 1.1402(a)-2(h)
^v https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf
^{vi} Federal Insurance Contributions Act of 1935
^{vii} Rev. Rul. 69-184
^{viii} Self-Employment Contributions Act of 1954
^{ix} IRC §1402(b)
^x IRC §1402(a)(13)
^{xi} https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf
^{xii} *ibid*
^{xiii} *ibid*
^{xiv} *Renkemeyer, Campbell & Weaver, LLP v. C.I.R. – 136 T.C. 137 (2011)*
^{xv} *Hardy v. Commissioner – T.C. Memo. 2017-16*
^{xvi} *Castigliola v. Commissioner – T.C. Memo. 2017-62*
^{xvii} *Riether v. United States – 919F. Supp. 2d 1140 (2012)*
^{xviii} CCA 201436049
^{xix} CCA 201640014
^{xx} Prop. Treas. Reg. 1.1402(a)-2(h)
^{xxi} IRS LB&I Concept Unit on Partnerships: https://www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf
^{xxii} *ibid*
^{xxiii} *ibid*
^{xxiv} Prop. Treas. Reg. 1.1402(a)-2(h)



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