Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:LI:TL-N-2629-01
TKerrigan

date:

to: Territory Manager (Communication, Technology & Media)
Attention: Group 1348-LMSB

from: Associate Area Counsel
CC:LM:FSH:BRK

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subject: [redacted]
Taxable years [redacted], [redacted], [redacted]
U.I.L. No. 1402.02-00

This memorandum responds to an April 20, 2001 request for assistance from Angelo Buonconsiglio of your staff concerning the application of the self-employment income tax provisions to the facts set forth below. This memorandum should not be cited as precedent.

FACTS

The relevant facts, as we understand them, are as follows: [redacted] is a domestic limited partnership located in [redacted], New York. The company manufactures and distributes natural [redacted] products. The partnership was formed on [redacted]. The two partners are [redacted] the general partner with a [redacted]% interest, and [redacted], the limited partner who owns the remaining [redacted]% interest. [redacted] is an S Corporation founded by [redacted] in [redacted]. The company is [redacted]% owned by [redacted] family members. Prior to the formation of the partnership, [redacted] was the principal business operating unit. [redacted] and his [redacted] were employees and officers of the S corporation. [redacted] transferred the manufacturing and distribution operations to [redacted] upon the creation of the partnership. Both [redacted] and [redacted] are now employees of the new partnership and receive their compensation from the [redacted].

During the examination of the partnership return, the revenue agent questioned the treatment of the compensation received by [redacted] and [redacted]. The taxpayer deducted the

amounts paid as employee wages. The agent believes that the [redacted] are "indirect" partners of the partnership pursuant to I.R.C. § 6231 and as such, their wages are actually payments to partners subject to self-employment tax. The taxpayer's position is that the S corporation owns the partnership interest and therefore, the [redacted] are properly treated as employees of the partnership.

ISSUE

Whether compensation paid by the taxpayer to two employees who are also shareholders of an S corporation that is the general partner of the partnership constitute guaranteed payments under I.R.C. § 707(c) subject to self-employment tax?

LEGAL ANALYSIS

I.R.C. § 1401 imposes a tax on self-employment income. I.R.C. § 1402(a) generally defines "net earnings from self-employment" as gross income from a trade or business less allowable deductions attributable to such trade or business. Income derived by an individual from carrying on a trade or business as a partner (other than a limited partner) in a partnership generally constitutes net earnings from self-employment. Treas. Reg. § 1.1402(a)-2(d). "Guaranteed payments" to partners 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 constitute net earnings from self-employment. I.R.C. § 1402(a); Treas. Reg. § 1.1402(a)-1(b). Treas. Reg. § 1.1402(c)-1, however, limits an individual's self-employment income to that income earned in carrying on a trade or business either as an individual or as a member of a partnership. Work performed as an employee is excluded from the definition of "trade or business" for self-employment tax purposes. I.R.C. § 1402(c)(2).

This case turns on the nature of the [redacted] ownership interests. Here, the [redacted] hold their interests through an entity separate from the partnership. The [redacted] are shareholders in the S corporation. The S corporation, not the [redacted], owns the partnership interest. Therefore, they are employees of the partnership and their wages are not subject to self-employment tax.[1/] This conclusion is consistent with a literal reading of I.R.C. § 1402, which excludes income earned as

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[1/] Their wages, however, are subject to the Federal Insurance Contribution Act ("FICA"), which imposes a tax on employees and employers for social security and medicare. I.R.C. § 3101.

an employee from the definition of self-employment income. We note that one commentator identifies an arrangement similar to the taxpayer's structure as the simplest way for individuals who receive an interest in a partnership to maintain employee status. See Sowell, Partners as Employees: A Proposal for Analyzing Partner Compensation, 2001 TNT 10-109 (2001). Finally, we note that current self-employment tax laws result in disparate outcomes and varying degrees of taxation depending upon the taxpayer's choice of entity. There is no uniform standard for flow though entities with respect to the self-employment tax. For example, an S corporation shareholder's distributive share of the net income of the S corporation is not subject to self-employment tax. See Rev. Rul. 59-221, 1959-1 C.B. 225 [S corporation shareholder's share of undistributed corporate taxable income does not constitute self-employment income]; Rev. Rul. 73-361, 1973-2 C.B. 331 [Shareholder of S Corporation who performed substantial services for the corporation and who received remuneration for those services is an employee of the corporation whose wages are subject to FICA tax]. The inconsistent treatment of an S corporation shareholder's distributive share and a partner's distributive share for self-employment tax purposes is statutorily based. In the present case, the taxpayer's choice of entity and ownership interest structure allow the [redacted] to qualify as employees of the partnership consistent with current employment tax provisions. Moreover, we note that prior to the current partnership arrangement, the [redacted], as S corporation shareholders, were not subject to self-employment tax. The formation of the partnership entity has resulted in no change for employment tax purposes since the [redacted] brothers are still employees subject to FICA. Before formation of the partnership, they were employees of [redacted]. Now, they are performing essentially the same duties as employees of [redacted].

The revenue agent's attempt to recharacterize wages as "guaranteed payments" and to treat the individual shareholders of the S Corporation as partners of [redacted] using the TEFRA provisions is not supported by the statutory framework outlined therein. The TEFRA audit procedures require consistent treatment of partnership items among all partners. I.R.C. § 6222. I.R.C. § 6231(a)(2) defines the term "partner" broadly to include any partner in the partnership plus any other person whose income tax liability is determined in whole or in part by taking partnership items into account, directly or indirectly. I.R.C. § 6231(a)(9) defines a "pass-thru" partner as an entity through which other persons hold an interest in a TEFRA partnership. An "indirect" partner is a person who claims a distributive share of a partnership through a "pass-thru" partner. I.R.C. § 6231(a)(10). In this case [redacted] is the "pass thru" partner and its shareholders are "indirect partners" for TEFRA purposes. These statutory definitions, however, are applicable only for purposes

of the TEFRA provisions as certain categories of partners have different rights and responsibilities with respect to a TEFRA partnership proceeding. In addition, the TEFRA subchapter contains a series of procedural rules rather than substantive tax provisions. Therefore, I.R.C. § 6231(a)(10) does not provide a requisite statutory authority for treating the wages paid to the [redacted] as guaranteed partnership payments subject to self-employment tax.

CONCLUSION

Based on the above, the compensation paid by the taxpayer to two employees who are also shareholders of the S corporation that is the general partner of the partnership are employee wages not subject to the self-employment tax.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

ROLAND BARRAL
Area Counsel

By: _____
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Associate Area Counsel