Active Limited Partners in the Investment Fund Industry and Self-Employment Taxes

Investment funds sometimes adopt a management structure that is intended to qualify certain limited partner income for an exclusion from self-employment tax. This type of arrangement is the subject of a pending Tax Court case—*Sands v. Commissioner*. This article discusses the case and considers what it might mean to taxpayers and the investment fund industry.

In general, section 1402(a)(13) excludes from self-employment taxes the distributive share of income or loss of a limited partner—other than for certain guaranteed payments for services rendered to the partnership by the partner. To qualify according to the literal terms of this exclusion, many participants in the investment fund industry have formed their management entity as a limited partnership in a jurisdiction that permits active participation in the entity's business by limited partners without forsaking limited liability. These individuals take the position that income allocated to them in their capacity as limited partners qualifies for the exclusion and is not subject to self-employment tax.

Recent cases and IRS administrative guidance have created some concern with this structure. Specifically, the Tax Court in *Renkemeyer v. Commissioner* and a U.S. district court in *Riether v. United States* determined that state law limited liability partners and limited liability company members did not qualify for the limited partner exception. Portions of these opinions highlighted the active participation of the partners/members and how this participation was inconsistent with the purposes of the limited partner exception. Subsequently, in Chief Counsel Advice 201436049, the IRS specifically challenged a structure in which the investment fund management entity was formed as a limited liability company and the members took the position that they were exempt from self-employment tax as limited partners.

Overview of the Taxpayer's Petition

On March 2, 2015, Frank M. Sands, Jr. (the "Taxpayer") petitioned the U.S. Tax Court for a redetermination of an IRS notice of deficiency for the Taxpayer's 2012 tax year. The assessment was related to approximately $436,000 in self-employment taxes owed on approximately $18.2 million in distributive income that was allocated to the Taxpayer as a limited partner in a state law limited partnership. These developments created concern within the investment fund industry that the IRS

was taking the next step in asserting its increasingly restrictive interpretation of the limited partner exception.

In the petition, the Taxpayer disagreed with the assessment and asserted that he should be statutorily excluded from self-employment taxes under section 1402(a)(13).

Overview of Relevant Organizational Structure

The Taxpayer's petition provided several relevant facts of the organizational structure through which the Taxpayer ultimately received his share of distributive income. At the lower-end of the structure, the petition noted the existence of an active investment management firm (with over 110 employees) by the name of Sands Capital Management, LLC ("Sands LLC"). Sands LLC was owned 99.32 percent by Sands Capital Management, LP and 0.68 percent by Sands Family Trust, LLC.

Sands Capital Management, LP ("Sands LP") was a state law limited partnership. While the specific ownership percentages of the partners of Sands LP were not provided in the Taxpayer's petition, the petition did provide that Sands LP would vest all management responsibility in its general partner, Sands Family Trust, LLC ("Sands Trust LLC"). In addition, the petition noted that the limited partnership of Sands LP was structured so as to treat the limited partners as investors who solely receive a share of the profits without any vote or influence in management decisions.

One of the limited partners of Sands LP, the F-J Sands Family I, LLC ("F-J LLC"), was treated as a disregarded single member LLC in the hands of the Taxpayer during the period that was the subject of the proposed assessment. The share of income to which F-J LLC was entitled from Sands LP was reported to it on a Schedule K-1, and there was no entry for self-employment income. As F-J LLC was treated as a disregarded entity in the hands of the Taxpayer, the Taxpayer reported items received on the Schedule K-1 from Sands LP directly on the Taxpayer's individual income tax return.

The Taxpayer served as a member of Sands Trust LLC which, as mentioned above, was the general partner of Sands LP. The share of income the Taxpayer received from his interest in Sands LP through the general partner interest held by Sands Trust LLC was subject to self-employment taxes and was reported as such on the Taxpayer's individual tax return.

The Taxpayer also served as the chief executive officer ("CEO") and chief investment officer ("CIO") of Sands LLC. In 2012, the Taxpayer received W-2 wage compensation for services rendered as the CEO and CIO of approximately $6.5 million. All of this income was subject to federal employment taxes.

The IRS's Response to Taxpayer's Petition

On May 8, 2015, the IRS filed its answer to the Taxpayer's petition and admitted that it had erred in asserting the proposed deficiency for self-employment taxes.

With the filing of the IRS's answer, what initially appeared to be a troubling development with regard to the limited partner exception now may be viewed as a favorable development. That is, the petition and answer illustrate a situation in which the IRS ultimately chose not to assess self-employment tax on a taxpayer who was active in an investment fund management entity and who received an allocation of management company income as a limited partner. It is possible that, upon reflection, individuals with authority at the IRS felt that the litigation risk with respect to the case was simply too great. In addition to the Taxpayer's status as a limited partner under state law, the fact that the

Taxpayer reported approximately $6.5 million as wages subject to employment taxes would seem to make this an unattractive case for the IRS to "test" its more restrictive interpretation of the limited partner exception. Without more than the court documents, however, it is impossible to know exactly what drove the decisions made in this case.

Are the Worries Over?

While the IRS's answer in *Sands* may imply that the IRS will be hesitant to assess self-employment tax against participants in an investment fund group's management entity who are allocated income as a limited partner under current law, there are signals that the law may soon change.

Specifically, the current Treasury Priority Guidance Plan lists as one of the anticipated guidance items: "guidance on the application of section 1402(a)(13) to limited liability companies." While Treasury and the IRS apparently are early in the process of considering the scope of this guidance, informal statements made by at least one individual participating in this guidance imply that the guidance may not be limited to the treatment of LLC members as limited partners, as the description seems to indicate. These statements leave open the possibility that the guidance could treat certain state law limited partners as other than limited partners for purposes of section 1402(a)(13).

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