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Tax Court Decision Addresses Self-Employment Taxes of LLC Members

Summary

In *Vincent J. Castigliola, et ux., et al. v. Commissioner*, TC Memo 2017-62, the Tax Court held that the three members of a Mississippi Professional Limited Liability Company ("PLLC") in the practice of law were subject to self-employment tax on their entire distributive share of the PLLC's income, despite the fact that they received guaranteed payments commensurate with local legal salaries. The case builds on existing judicial authority in an area where statutory and regulatory guidance is lacking.

Background

During the years in question, the three taxpayers were attorneys licensed to practice law in the State of Mississippi. On July 12, 2001, they reorganized their law firm as a professional limited liability company—Bryan, Nelson, Schroeder, Castigliola & Banahan, PLLC. They were each engaged in the practice of law solely through their PLLC. The members' compensation agreement required guaranteed payments to each member that were commensurate with local legal salaries, as determined by a survey of legal salaries in the area. Any net profits of the PLLC in excess of amounts paid out as guaranteed payments were distributed among the members in accordance with the members' agreement.

Section 1401(a) imposes a tax on the self-employment income of individuals (self-employment tax). The base for self-employment tax is generally "net earnings from self-employment" ("NESE") as defined by section 1402 and includes a taxpayer's "distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member." Section 1402(a)(13) provides an exclusion from self-employment income for "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner 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."

The taxpayers in *Castigliola* did not dispute that their guaranteed payments were subject to self-employment tax, but contended that their distributive share of PLLC income in excess of those guaranteed payments should be excluded from NESE under section 1402(a)(13). The IRS argued that the taxpayers were not limited partners within the meaning of section 1402(a)(13), so that the exclusion did not apply. Accordingly, the question addressed by the Court was whether the taxpayers were limited partners within the meaning of the statute.

Citing *Renkemeyer, Campbell, & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011) ("*Renkemeyer*"), the Court noted that no statutory or regulatory authority defines the term "limited partner" for purposes of section 1402(a)(13), and that as a result, it is necessary to apply accepted principles of statutory construction to ascertain congressional intent, giving the term its ordinary meaning at the time of enactment. Therefore, in *Castigliola*, the Court reviewed the history of the Revised Uniform Limited Partnership Act ("RULPA") and its application by various States, and concluded that the primary characteristics of a limited partner common to each State are limited liability and lack of control of the business. The taxpayers in this case were each found to have participated in control of the business of their PLLC: they all participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. As such, the Court concluded that the taxpayers could not have qualified as limited partners under any version of the RULPA and were not limited partners under section 1402(a)(13).

Comments

Castigliola closely follows the Tax Court's earlier decision in *Renkemeyer* in concluding that the meaning of the term "limited partner" for purposes of section 1402(a)(13) must be determined based on Congressional intent, and not, for example, by state law designations. Thus, it is conceivable that a taxpayer who is a limited partner under state law may not be a limited partner for purposes of section 1402(a)(13), although no court has yet addressed that fact pattern. The *Castigliola* court's reliance on the RULPA in determining the characteristics of a limited partner imply that the circumstances under which a state-law limited partner would not qualify for the 1402(a)(13) exclusion may be very narrow.

Both decisions are largely consistent with Prop. Reg. section 1.1402(a)-2, which provides generally that for this purpose, an individual member of an organization classified as a partnership for federal tax purposes is treated as a limited partner unless he (i) has personal liability for the debts of or claims against the partnership by reason of being a partner; (ii) has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or (iii) participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year. The proposed regulations were issued in 1997 and the timeline for their finalization remains uncertain. However, the IRS has stated informally that taxpayers may rely on them.

Insights

Members of entities classified as partnerships and their tax advisors should consider *Castigliola* and the other authorities cited in this alert in determining whether their distributive share of the entity's trade or business income can be excluded from NESE under section 1402(a)(13). Particularly when a member is not specifically designated as a limited partner under State law, such member should determine whether he or she would be treated as a limited partner under Prop. Reg. section 1.1402(a)-2, and alternatively whether he or she meets the Congressional intent test applied by the Tax Court in *Renekemeyer* and *Castigliola*. A corresponding analysis should be performed by entities in preparing Schedules K-1 for their individual members. The analysis should take into account the member's liability for entity level debts by reason of being a member (as opposed to liability as a guarantor, for example), the member's authority to control the entity's business, and the nature and extent of any services he or she provides.