SAME STANDARD, DIFFERENT TAXES: THE IRS AND NEW YORK ATTACK LIMITED PARTNER EXCEPTION

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The limited partner exception to net earnings from self-employment has been a crucial and controversial issue at the *federal* level for several decades .... Now, New York has upped the ante even further by auditing and imposing the Mobility Tax on taxpayers engaged in business in the MCTD.

Many people are blindsided each year, not just by cars, but also by the Internal Revenue Service ("IRS") and state tax authorities. Indeed, taxpayers who are unaware of critical tax laws, the evolving interpretation of such laws, and/or their potential overlap at the federal and state level often find themselves on the short end of the fiscal stick. A good example involves partnerships and the exclusion of distributions to "limited partners" from the definition of "net earnings from self-employment." The issue is not new; the relevant laws have existed for many years. However, taxpayers and their advisors are beginning to pay attention because both the IRS and the New York State Department of Taxation and Finance ("Department") are aggressively auditing and challenging the so-called limited partner exception for different reasons.

This article, another in a series, offers a history of the relevant rules, explains pending Tax Court disputes concerning the proper treatment of limited partners, describes current audits and positions by the Department on the same question, and warns of the need to stay informed about the advancement of federal *and* state battles given the use of the same standards in both instances.[1]

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SECA taxes: A survey of guidance

Confusion over Self-Employment Contributions Act ("SECA") taxes in the partnership context has persisted for decades, mainly as the result of nonexistent, changing, or conflicting guidance. Below are some major items from the beginning.

SECA tax starts in 1950. Compensation earned by taxpayers ordinarily is subject to employment taxes. When it comes to sole proprietors, independent contractors, and partners, the two main components are income taxes and the SECA taxes.[2] The latter funds the Social Security and Medicare programs.

Congress introduced the SECA tax in 1950, applying it to "net earnings from self-employment."[3] This phrase is critical to this article. It generally means gross income derived by an individual from any trade or business carried on by such individual, minus certain business-related deductions, plus his distributive share of income from any partnership in which he is a partner.[4] Initially, distributive shares to *all* partners, both general and limited, were subject to the SECA tax.[5] The regulations made this clear: "The net earnings from self-employment of a partner include his distributive share of the income or loss . . . of the partnership of which he is a member, *irrespective of the nature of his membership.* Thus, in determining his net earnings from

self-employment, *a limited or inactive partner includes his distributive share of such partnership income or loss*."[6]

Limited partner exception appears in 1977. Things radically changed in 1977 when Congress developed a carve-out for limited partners about a quarter-century later. Congress enacted the predecessor to Section 1402(a)(13), which states the following: "[T]here *shall be excluded* [from net earnings from self-employment] the distributive share of any item of income or loss of a *limited partner, as such*, other than guaranteed payments . . . 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."[7] Putting it in simpler terms, Section 1402(a)(13) *excludes* from the definition of net earnings from self-employment, and thus from SECA tax, the distributive share to a "limited partner," in his capacity as a limited partner.[8] This exception does not apply, however, in cases where a partnership makes "guaranteed payments" to a limited partner in exchange for services rendered.[9] In other words, where a partner receives set payments for rolling up his proverbial sleeves, he must pay SECA tax on that income.

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Understanding why Congress created Section 1402(a)(13) is pivotal. The IRS and several courts have focused on the following portion of the legislative history: "Under [the previous law enacted in 1950], *each partner's share* of partnership income is *includable* in his net earnings from self-employment for Social Security purposes, irrespective of the nature of his membership in the partnership. The bill would *exclude* from Social Security coverage the distributive share of income or loss received by a *limited partner* from the trade or business of a limited partnership. This is to exclude for [Social Security] coverage purposes certain earnings which are basically of an investment nature . . . ."[10]

Most people are clueless as to why Congress created the limited partner exception in the first place. The reason will astonish many readers. A careful reading of the *entire* legislative history, not just the snippet featured above, reveals that Congress was concerned in 1977 about one situation. In particular, Congress had been informed that (i) persons were selling limited partner interests solely for purposes of allowing certain individuals to become eligible to receive Social Security benefits, (ii) the individuals were not investing in the normal sense of the word, not risking money with hopes of getting passive income in return, (iii) the individuals were not paying a significant amount of SECA tax because they were making small capital contributions and receiving equally small distributive shares, (iv) the individuals were obtaining unfairly large Social Security benefits to the detriment of all workers financing the program, and (v) many government workers, ironically, were participating in this improper scheme because they could not otherwise participate in the Social Security program.

Readers might ask themselves why anyone would take pro-active steps to pay the SECA tax. Well, it made sense several decades ago, because at that time the SECA tax rate was low (it was 2.25 percent initially and only 7.9 percent in 1977) and the

[1] This article supplements earlier ones by the same author. *See* Hale E. Sheppard, "Analyzing the Long Journey to Chaos: SECA Taxes, Limited Partner Exception, and Effects of Government Inaction," 48(6) *Journal of Corporate Taxation* 3 (2021); Hale E. Sheppard, "Heads the IRS Wins, Tails Taxpayers Lose: Analyzing Inconsistent Positions on the Meaning of 'Limited Partners,'" 49(2) *Journal of Corporate Taxation* 3 (2022); Hale E. Sheppard, "The Resurgence of IRS Disputes about Which Limited Partners Escape SECA Taxes Thanks to the Section 1402(a)(13) Exception," 49(1) *Journal of Corporate Taxation* 18 (2022); Hale E. Sheppard, "New Tax Court Case Shows that the IRS is Getting 'Sirius' about SECA Taxes and the Limited Partner Exception," 49(6) *Journal of Corporate Taxation* 13 (2022); Hale E. Sheppard, "Tax Court Showdown over SECA Taxes and Limited Partners: Exploring the Catalyst for the Second Case of Many," ___ *Journal of Corporate Taxation* ___ (2023).

[2] Section 1401(a) and (b); Revenue Ruling 69-184.

[3] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax (Sept. 2012), pg. 1; Section 1401(a) and (b).

[4] Section 1402(a).

[5] T.D. 7333 (Dec. 19, 1974); Treas. Reg. § 1.1402(a)-2(d).

[6] Treas. Reg. § 1.1402(a)-2(g) (emphasis added).

[7] Social Security Amendments of 1977, Public Law No. 95-216, Section 313(b); Section 1402(a)(13) (emphasis added).

[8] Section 1402(a)(13).

[9] Section 1402(a)(13).

[10] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), pg. 11 (emphasis added).

[11] Laura E. Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70(4) Washington and Lee Law Review 2389 (2013) (explaining that the SECA tax rate was merely 7.9 percent and it applied only to the first $16,500 of net earnings).

[12] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).

long-term value of the Social Security benefits far outweighed the tax burden.[11]

First proposed regulations in 1994. After chewing on the matter for about two decades, the IRS issued its first set of proposed regulations about Section 1402(a)(13) in 1994 ("First Proposed Regulations").[12] They contained rules for treatment of limited partners in partnerships, as well as members of limited liability companies ("LLCs") treated as partnerships.[13] The First Proposed Regulations explained that a member of an LLC would be treated as a "limited partner" for purposes of Section 1402(a)(13), and thereby *not* obligated to pay SECA tax, if two criteria were met. First, the member could not be a "manager" of the LLC.[14] Second, the LLC could have been formed as a limited partnership, instead of an LLC, and the member could have qualified as a limited partner, instead of a member.[15]

Second proposed regulations in 1997. The IRS decided to revamp its approach after reviewing public comments to the First Proposed Regulations. In 1997, it withdrew the First Proposed Regulations and replaced them with a new set ("Second Proposed Regulations").[16] This time, the IRS provided guidance covering *all* entities classified as partnerships for federal tax purposes. The updated rules encompassed limited partnerships, LLCs, limited liability partnerships ("LLPs"), and other entities that had emerged since Congress introduced the limited partner exception 20 years earlier.[17] The Second Proposed Regulations maintained the exception in Section 1402(a)(13), but changed the definition of "limited partner."[18] They stated that an individual was *presumed* to be a limited partner, *unless* (i) he was personally liable for the debts or other claims against the partnership based on his status as a partner, *or* (ii) he had authority under state law to engage in contracts for the partnership, *or* (iii) he participated in the partnership's business more than 500 hours during a year.[19]

The Second Proposed Regulations also indicated that an individual who was a "service partner" in a "service partnership" would *not* be a limited partner.[20] For these purposes, the term "service partner" meant a partner who provided services either to a partnership or on behalf of its trade or business.[21] A "service partnership," meanwhile, was a partnership substantially all of whose activities involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[22]

Congressional moratorium in 1997. Congress stopped the IRS in its tracks in 1997 by enacting a law expressly prohibiting the IRS from finalizing the Second Proposed Regulations, at least temporarily. The law stated that "[n]o temporary or final regulation with respect to the definition of limited partner under Section 1402(a)(13) . . . may be issued or made effective before July 1, 1998."[23] This essentially created a moratorium on regulations for about 18 months. If that were not enough, Congress suggested in the legislative history that the IRS should withdraw the Second Proposed Regulations and that only "Congress should determine the tax law governing self-employment income."[24] In summary, Congress halted the IRS, declaring that the legislative branch (*i.e.*, Congress), and not an agency of the executive branch (*i.e.*, the IRS), had authority to create law regarding the definition of limited partner.

Relevant case. Several cases and IRS rulings have wrestled with the limited partner exception over the years.[25] The most famous dispute, and

[13] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18 (Dec. 29, 1994).

[14] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(b)(1) (Dec. 29, 1994).

[15] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18(b)(2) (Dec. 29, 1994).

[16] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.

[17] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96 (stating that "[t]hese proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity.")

[18] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(g).

[19] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(2).

[20] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(5).

[21] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(i).

[22] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(ii).

[23] Taxpayer Relief Act of 1997, Public Law 105-34, Section 935 (Aug. 5, 1997).

[24] U.S. House of Representatives. Taxpayer Relief Act of 1997, Conference Report, 105th Congress, 1st Session, Report 105-220, July 30, 1997, pg. 765.

[25] *See, e.g., Johnson v. Commissioner*, T.C. Memo 1990-461; *Perry v. United States*, T.C. Memo 1994-215; Private Letter Ruling 9432018; Private Letter Ruling 9452024; Private Letter Ruling 9525058; *Norwood v. Commissioner*, T.C. Memo 2000-84; *Riether v. United States*, 919 F. Supp. 2d 1140 (2012); *Howell v. Commissioner*, T.C. Memo 2012-281; Chief Counsel Advice 201436409; Chief Counsel Advice 201640014; *Hardy v. Commissioner*, T.C. Memo 2017-16; *Castigliola v. Commissioner*, T.C. Memo 2017-62; *Joseph v. Commissioner*, T.C. Memo 2020-65.

arguably the only one with precedential value, is *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*.[26] The taxpayers formed an LLP under Kansas law to operate their law practice ("Law Firm"). The Law Firm had three individual partners, each of whom held a General Manager Partner Interest and an Investment Partner Interest, had equal authority, and was entitled to an equal distributive share. The Law Firm filed timely Forms 1065 (U.S. Return of Partnership Income) showing revenues primarily generated from the performance of legal services. Such revenues were distributed to the individual partners, not reported as net earnings from self-employment, and thus not subjected to SECA tax.

The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares as net earnings from self-employment, not protected by the limited partner exception. The Law Firm challenged the IRS in Tax Court. It argued that its three partners should be treated as limited partners under Section 1402(a)(13) because (i) they were partners in an LLP formed under Kansas law, (ii) their interests were called limited partner interests in the Law Firm's organizational documents, and (iii) each of the partners had limited liability under Kansas law.

The Tax Court disagreed. It explained that the predecessor to Section 1402(a)(13), which used the phrase "limited partner," was enacted *before* LLPs and other modern entities came into existence. It then recognized that the IRS attempted to address this issue many years ago, in 1997, by issuing the Second Proposed Regulations, but Congress prevented the IRS from finalizing them. Without any additional guidance since then, from either Congress or the IRS, the Tax Court indicated that it was forced to engage in statutory interpretation to determine what, exactly, Congress meant when it used the term "limited partner." The Tax Court looked to just one small portion of the legislative history, which stated that Congress introduced Section 1402(a)(13) to exclude "certain earnings which are basically of an investment nature.[27]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount for their partnership interests, and the distributive shares that they received were not returns "basically of an investment nature." Accordingly, the Tax Court concluded that the partners had to pay SECA taxes on the amounts received, and the exception under Section 1402(a)(13) did not apply.[28]

Compliance campaign in 2018. The IRS believed that certain taxpayers persisted in improperly taking advantage of Section 1402(a)(13). According to the IRS, some entities treated as partnerships were classifying *all* members as limited partners, thereby avoiding SECA tax altogether. Other partnerships were taking a more moderate approach, arguing that only a portion of the distributions were hit by SECA tax. They accomplished this by labeling small amounts as wages or guaranteed payments to partners, while classifying the majority as distributive shares to limited partners. The IRS initiated a Compliance Campaign in 2018 to scrutinize these practices.[29]

Promises of litigation in 2021. The IRS must have disliked what it discovered when carrying out its Compliance Campaign, as attorneys from the National Office announced in 2021 that the IRS planned to continue auditing and litigating SECA tax cases involving limited partners.[30]

Limited partner issues: Federal level

The IRS has advanced its agenda of attacking partnerships that exclude all or part of their distributions from SECA tax. Below are two disputes that have reached the Tax Court already, with many more on the way in the near future.

First case: *Sirius Solutions, LLLP v. Commissioner*.[31]
Sirius Solutions, LLLP ("Sirius") is a limited liability limited partnership formed in Delaware and governed by a Limited Partnership Agreement. Sirius is a consulting firm with over 200 employees located in various offices. It is managed by Sirius Solutions GP, LLC ("General Partner"). The Limited Partnership Agreement prohibits limited partners from participating in management or control of the business. It also forbids limited partners from transacting business for, acting on behalf of, or binding Sirius. Finally, it does not allow for any "guaranteed payments" to partners, and Sirius made no such payments.

At the end of 2014, the only year at issue with the IRS, five individual limited partners and the General Partner owned Sirius. All limited partners made capital contributions, many of which were significant. Some partners, in addition to providing cash, contributed services to Sirius. Sirius made distributions of "net cash flow" to the limited partners in 2014 in accordance with their ownership interests. Such distributions were not linked to, or dependent upon, hours worked, revenues generated, or any other formula related to services provid-

ed by the limited partners. Indeed, the limited partners who provided few or no services received the same pro-rata distributions.

Sirius took the position on its Form 1065 for 2014 that the distributions to the limited partners were not subject to SECA tax thanks to the exception in Section 1402(a)(13). The IRS later audited Sirius and issued a notice of Final Partnership Administrative Adjustment ("FPAA") alleging that (i) the ordinary income generated from the business consulting services should be included in net earnings from self-employment, (ii) the individual partners do not fall within the exception for limited partners, and (iii) the amount of net earnings from self-employment should increase from $0 to approximately $6 million.

Sirius disagreed with the IRS's position in the FPAA, of course, and challenged it by tendering a Petition to the Tax Court. The parties completed their initial pleadings, the trial was postponed, and Sirius submitted a Motion for Summary Judgment during the reprieve. Sirius asked the Tax Court to determine, without a trial, that distributions to individuals who are limited partners according to relevant state law are excluded from SECA taxes under Section 1402(a)(13), period. The IRS opposed the Motion for Summary Judgment.

The Tax Court, stingy on details, released an Order in August 2022 denying the Motion for Summary Judgment filed by Sirius. The Order indicated that a comprehensive ruling was premature because material facts remain unresolved with respect to the ordinary meaning of the term "limited partner" as used in Section 1402(a)(13), as well as the involvement of the partners in business operations.[32] The dispute, therefore, appears to be heading to trial.

Second case: *Soroban Capital Partners, LP v. Commissioner.*[33] The dispute is in the early stages, but the parties have presented the following data to the Tax Court thus far.[34]

The entity at issue, Soroban, was a Delaware limited partnership during the relevant years. To be clear, it was a limited partnership, consistent with the terminology in the SECA tax exception in Section 1402(a)(13), not another type of entity merely treated as a partnership for tax purposes. Soroban was a hedge fund. It provided various services related to the management of private investment funds, including buying and selling securities and other instruments.

The IRS apparently audited Forms 1065 for 2016 and 2017, concluding that Soroban had understated net earnings from self-employment by approximately $142 million. The IRS did *not* propose any penalties, though. Soroban disputed the IRS's allegations by filing Petitions with the Tax Court. The Petitions indicate that Soroban had one general partner, three limited partners, and 27 individual employees whose work contributed to the profits. Two of the limited partners held their interests in Soroban through single-member LLCs treated as disregarded entities, while one held his interest personally.

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The Limited Partnership Agreement dictated that (i) only the general partner could manage, operate, and control Soroban, (ii) although the limited partners had to approve certain events before they could occur, the general partner had the "ultimate authority" to take actions or make decisions, (iii) the partners had limited liability, and (iv) the partners would receive allocations of profit and loss pursuant to their ownership percentages. The Petition pointed out that the limited partners had lim-

26 *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011).

27 *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011) (citing the Social Security Amendments of 1977, Public Law 95-216, Section 313(b)).

28 *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011).

29 *"Large Business and International Active Campaigns," IRS (2023). Available at: https://www.irs.gov/businesses/corporations/lbi-active-campaigns.*

30 Kelley R. Taylor, "Clarity regarding 'Limited Partner' under SECA Remains Elusive," 2021 Tax Notes Today Federal 112-2 (June 11, 2021).

31 *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20. The facts, arguments and issues described in this article derive from the following sources: Notice of Final Partnership Administrative Adjustment dated June 12, 2020; Petition filed September 3, 2020; Answer filed November 11, 2020; Joint Motion for Continuance filed March 8, 2021; First Stipulation of Facts filed June 2, 2021; Motion for Summary Judgment filed June 4, 2021; Brief in Support of Motion for Summary Judgment filed June 4, 2021; Reply in Support of Petitioner's Motion for Summary Judgment and to Petitioner's Brief in Support of Motion for Summary Judgment filed August 13, 2021; Sur-Reply in Opposition of Petitioner's Motion for Summary Judgment and Petitioner's Brief in Support of Motion for Summary Judgment filed September 13, 2021; First Supplemental Stipulation of Facts filed December 3, 2021; and Respondent's Response and Brief in Opposition to Petitioner's Motion for Summary Judgment and to Petitioner's Brief in Support of Motion for Summary Judgment filed December 16, 2021.

32 *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20, Order issued Aug. 8, 2022.

33 *Soroban Capital Partners, LP v. Commissioner*, Tax Court Docket Nos. 16217-22 and 16218-22.

34 *Soroban Capital Partners, LP v. Commissioner*, Tax Court Docket Nos. 16217-22 and 16218-22. Petitions dated July 22, 2022, and Answers dated Sept 15, 2022.

ited liability for any problems stemming from Soroban under Delaware law, too.

The Petitions underscored that everyone respected the limited partnership form. They alleged, in particular, that the general partner performed all management functions, the limited partners did not participate in the management of Soroban "to any extent" in their capacities as limited partners, the limited partners received Schedules K-1 (Partner's Share of Current Year Income, Deductions, Credits, and Other Income) identifying them as limited partners, the general partner paid SECA tax on its distributive share, and the 27 employees paid federal income taxes on their compensation through withholding.

The Petitions acknowledged that the three limited partners (i) devoted considerable hours to working for Soroban, the general partner, and other affiliates, (ii) held different positions for Soroban, including Managing Partner, Co-Managing Partner, Chief Investment Officer, and Head of Trading and Risk Management, and (iii) were members of the Management Committee. The Petitions explained that Soroban made "guaranteed payments" to the limited partners for providing such services and subjected those payments to SECA taxes. The Petitions further indicated that the other amounts directed to each of the three limited partners (*i.e.*, their distributive shares) did not constitute compensation for services rendered to or on behalf of Soroban, such that they were *not* exposed to SECA taxes.

The IRS, predictably, filed Answers with the Tax Court denying essentially all the allegations Soroban made in its Petitions.

Limited partner issues: State level

Facing attacks by the IRS is a burden to partnerships, but fending off challenges from *both* the IRS and state tax authorities on the same issue raises the stakes considerably. This is precisely what is happening to partnerships conducting business in New York City and surrounding areas.

Overview of the mobility tax. The state of New York enacted the Metropolitan Commuter Transportation Mobility Tax Act ("Mobility Tax") in 2009.[35] It was created to mitigate fare increases and service decreases adopted earlier that year by the Metropolitan Transit Authority ("MTA"). Specifically, the "sole purpose" of the Mobility Tax was to provide a "stable and reliable funding source for the [MTA] and its subsidiaries and affiliates to preserve, operate and improve essential transportation and transit services" in the greater New York City area.[36]

The Department handles implementation and enforcement. The Mobility Tax applies to certain employers and self-employed individuals engaged in business in any of the 12 counties comprising the Metropolitan Commuter Transportation District ("MCTD"). This includes all five boroughs of New York City (*i.e.*, Manhattan, Brooklyn, Queens, Staten Island, and the Bronx), along with seven other surrounding areas.[37]

This article looks at the application of the Mobility Tax to self-employed individuals, which includes partners in partnerships and similar entities. The Department broadly describes the scope of the Mobility Tax as follows: "The [Mobility Tax] is imposed on self-employed individuals (including partners or members in partnerships, limited liability partnerships (LLPs) that are treated as partnerships, and limited liability companies (LLCs) that are treated as partnerships) engaging in business within the [MCTD]."[38]

The amount of the Mobility Tax, by itself, is relatively small. It is just thirty-four hundredths percent, or .0034, of the "net earnings from self-employment" allocated to a business carried on within the MCTD.[39] Initially, an individual faced the Mobility Tax only if his net earnings from self-employment attributable to the MCTD exceeded $10,000. This barrier changed in favor of taxpayers in 2012, with the threshold increasing to $50,000.[40] A simple example puts the Mobility Tax into financial perspective. If a partner in a partnership carrying on business activity within the MCTD receives a distributive share of $100,000 and no exceptions apply, then the partner's Mobility Tax would be $340. That figure seems manageable, and many taxpayers might just pay it to avoid the hassle, treating it as a nuisance settlement. However, what would happen if the distributive share jumped to $10 million? The Mobility Tax would increase to $34,000

[35] New York Assembly Bill A08180 (May 7, 2009); Article 23 of the New York Tax Law; Phil Tatarowicz and Rebecca Bertothy, "Multistate Taxation," 10 Corporate Business Taxation Monthly 5 (Aug 2009).

[36] New York Tax Law § 801(a).

[37] *Ibid.*

[38] 2010 Instructions for Form MTA-6 (Metropolitan Commuter Transportation Mobility Tax Return for Self-Employed Individuals, including Partners).

[39] New York Tax Law § 801(a)(2).

[40] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Legislative Amendments to the Metropolitan Commuter Transportation Mobility Act, TSB-M-12(1)MCTMT, Jan 26, 2012.

[41] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-M-09(1)MCTMT, June 1, 2009, pg. 5; New York State Department of Taxation and Finance, Publication 420 (Guide to the Metropolitan Commuter Transportation Mobility Tax), Aug 2015, pg. 17.

every single year. Taxpayers might not take an annual liability of that size so lightly.

Specific aspects of the law. Readers should understand various aspects of the Mobility Tax. First, unlike the SECA tax, the Mobility Tax is not capped. Only the first $147,000 of net earnings from self-employment are subject to SECA tax for federal purposes, but no such limit exists when it comes to the Mobility Tax.[41] Thus, partners receiving hefty distributions from partnerships with sufficient links to the MCTD confront large Mobility Tax liabilities, despite its low rate.

Second, the Department expansively defines the concept of carrying on business activity. A partnership carries on a business, trade, profession or occupation within the MCTD if it maintains or operates an office, shop, store, warehouse, factory, agency, "or any other place" in the MCTD where its affairs are "systematically and regularly" carried on. Even if it lacks a fixed location, a partnership can still conduct a business activity within the MCTD if it performs a series of acts or transactions for profit with "a fair measure of regularity and continuity," as opposed to isolated or incidental acts or transactions.[42] The concept of carrying on a business activity is vast for purposes of the Mobility Tax, encompassing a partnership that is engaged in continuous, frequent, or regular activities.[43]

Third, taxpayers often must calculate what portion of their business activities occurred within the MCTD.[44] Things are simple if all events take place in the MCTD; 100 percent of the net earnings from self-employment are subject to the Mobility Tax. Matters get more complicated, though, when work happens both inside and outside the MCTD. In situations where taxpayers maintain books and records that "fairly and equitably" show the apportionment of the net earnings, they can rely on those. Where reliance documentation is absent, taxpayers must utilize the business-allocation formula or another method approved by the Department. As for partners and members of LLCs treated as such, they must seek allocation data from the partnership.[45]

Fourth, the Department is clear in describing Mobility Tax obligations for owners of certain pass-through entities. It indicates that "[i]f a partnership is doing business within the MCTD, each partner will be subject to the [Mobility Tax] based on his or her share of the partnership's net earnings from self-employment allocated to the MCTD."[46] The Department expressly states that the term partnership encompasses LLCs, LLPs, and other entities treated as partnerships for federal tax purposes.[47] The Department further explains that, instead of having each partner make estimated Mobility Tax payments throughout the year and file separate reconciliation returns at the end, certain partnerships may elect to make group estimated tax payments for the participating partners and then file a group reconciliation return.[48] Finally, the Department requires that partnerships doing business within the MCTD generally must make estimated Mobility Tax payments on behalf of individual partners who are not residents of New York State.[49] It emphasizes that "nonresident alien partners are not exempt from the [Mobility Tax] even though they may be exempt from federal [SECA taxes].[50]

Partners receiving hefty distributions from partnerships with sufficient links to the MCTD confront large Mobility Tax liabilities, despite its low rate.

[42] New York Statement Department of Taxation and Finance, Instructions for Form IT-204 (Partnership Return and Related Forms) (2002), pgs. 2 and 8; New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-M-09(1)MCTMT, June 1, 2009, pgs. 5-6; New York State Department of Taxation and Finance, Publication 420 (Guide to the Metropolitan Commuter Transportation Mobility Tax), Aug 2015, pg. 17; 20 New York Codes, Rules and Regulations 132.14.

[43] New York State Department of Taxation and Finance, Office of Counsel, Advisory Opinion Unit, TSB-A-13(2)MCTMT, Oct. 17, 2013.

[44] 20 New York Codes, Rules and Regulations §132.15.

[45] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-M-09(1)MCTMT, June 1, 2009, pg. 6; New York Tax Law § 801(b)(1); New York State Department of Taxation and Finance, Form IT-203-A (Business Allocation Schedule); New York State Department of Taxation and Finance, Publication 420 (Guide to the Metropolitan Commuter Transportation Mobility Tax), Aug 2015, pg. 18.

[46] New York State Department of Taxation and Finance, Publication 420 (Guide to the Metropolitan Commuter Transportation Mobility Tax), Aug 2015, pg. 22.

[47] *Ibid.*

[48] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax Group Estimated Tax Payments and Group Returns for Partners, TSB-M-09(2)MCTMT, August 5, 2009; Phil Tatarowicz and Rebecca Bertothy, "Multistate Taxation," 11 Corporate Business Taxation Monthly 5 (Oct. 2009).

[49] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-M-09(1)MCTMT, June 1, 2009, pgs. 8-9. Exceptions for nonresidents exist where the partnership elects the group payment and filing method described above or where a partner certifies to the partnership that he will comply with his duties in his individual capacity.

[50] New York State Department of Taxation and Finance, Publication 420 (Guide to the Metropolitan Commuter Transportation Mobility Tax), Aug 2015, pg. 23.

Fifth, the law contains a mechanism designed to prevent changing the character of certain income when it comes to multi-tier partnerships. It explains that New York source income (and presumably MCTD source income) of a nonresident partner includes the partner's distributive share of all items of partnership income, gain, loss and deduction comprising the partner's *federal* Adjusted Gross Income, to the extent that such items are derived from or connected with local sources. These include items attributable to "a business, trade, profession, or occupation carried on in New York State by the partnership."[51] The law also features specific rules for multi-tier structures. It dictates that when a nonresident partner is a partner in an Upper-Tier Partnership, and the Upper-Tier Partnership, in turn, is a partner in a Lower-Tier Partnership, the source and character of a nonresident partner's distributive share from the Upper-Tier Partnership that is attributable to the Lower-Tier Partnership retains the source and character determined at the Lower-Tier Partnership level. In other words, the tax attributes do not change solely because items flowed through the Upper-Tier Partnership to the nonresident partner.[52]

Sixth, the Department warns that violations of Mobility Tax obligations can trigger tax liabilities, various delinquency sanctions (for late filing and/or late payment), and interest charges.[53]

Seventh, speculation and uncertainty about the application of the Mobility Tax to complicated partnership arrangements has existed from the outset. Commentators observed the following way back in 2009:

> The [Mobility Tax] does not address how [it] applies to complex partnership structures, such as alternative investment fund managers. For example, with regard to alternative investment funds, if the fund is carrying on a trade or business in the MCTD (*e.g.*, loan origination), the income received by the general partner will be considered earnings from self-employment. Generally, most investment managers are structured as limited partnerships . . . with the principals directly invested as limited partners, and an LLC as the general partner. The principals of the investment manager are generally members of the general partner LLC. Based on the new law [creating the Mobility Tax], the guaranteed payments made by the investment manager to its principals as limited partners would be considered net earnings from self-employment, as well as the principals' share of the management and incentive fee earned through the general partner vehicle. The principals' guaranteed payment and general partner income from the investment manager would be subject to the [Mobility Tax] based on the investment manager's apportionment to the MCTD. The principals' general partner income will be subject to the [Mobility Tax] based on the allocation to the MCTD of the fund's trade or business income.[54]

State reference to federal standard. The critical aspect of the Mobility Tax, at least when it comes to this article, is that it *expressly* incorporates federal standards. As explained above, the Mobility Tax affects self-employed individuals, including partners or members in partnerships, LLCs, LLPs, and other entities treated as partnerships that engage in business within the MCTD .[55] The law specifically states that the Mobility Tax affects the "net earnings from self-employment of individuals that are attributable to the MCTD."[56]

Then, when it comes to definitions, New York law instructs taxpayers to check federal law, because "net earnings from self-employment [for purposes of the Mobility Tax] has *the same meaning* as in Section 1402 of the Internal Revenue Code."[57] New York law thus references and utilizes the *federal* standard in deciding whether it should impose its own *state* tax. As a reminder, when it comes to federal law, the following item is *not* part of net earnings from self-employment: "The distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments . . . 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."[58]

Positions by the department. What does all this mean for partners with interests in partnerships engaged in business activities within the MCTD? We know a few things.

For starters, we know that the Department, like the IRS, is in the process of aggressively auditing partnerships, often taking the position that no part of the distributions to alleged limited partners should escape the definition of net earnings from self-employment under Section 1402(a)(13). Thus, from the Department's perspective, the Mobility Tax should apply to all amounts.

We also know that in construing New York law, the Department will cite to federal tax law, and by extension to IRS rulings, Tax Court cases, and other authorities interpreting such law. The apparent logic here is that such reliance is appropriate since the New York law creating the Mobility Tax specifically references the Internal Revenue Code. In recent disputes with partnerships conducting business within the MCTD, the Department has alluded to various federal sources in an effort to support a broad application of the Mobility Tax. For instance, it looks to *Renkemeyer*, the only Tax Court case with precedential value regarding the limited partner exception. As readers recall, that case involved what the IRS characterizes a "service partnership," where the

Law Firm derived nearly all its revenue from legal services, the partners made minimal capital contributions to the partnership, the partners provided substantial services and equally managed the business, and the distributions to the partners were not akin to passive returns on investment.[59]

The Department also points to another Tax Court case, *Castigliola v. Commissioner*.[60] The taxpayers in that case were also a group of attorneys who practiced law through a firm organized as a professional limited liability company ("PLLC") in Mississippi.[61] The PLLC was treated as a partnership for federal tax purposes, filing an annual Form 1065. During the relevant years, the firm had a Compensation Agreement, which called for guaranteed payments to the members. Any remaining amounts were distributed to the members. Based on the advice of their longstanding accountant, the taxpayers reported the guaranteed payments, but not the distributions, as net earnings from self-employment. The IRS audited and claimed that *all* amounts received from the PLLC should have been subject to SECA taxes. The PLLC disagreed, and litigation ensued. The Tax Court began by summarizing *Renkemeyer*. Based on that case, the Tax Court held that its first job was to determine whether the party claiming the benefit of the limited partner exception held a position that is "functionally equivalent" to that of a limited partner in a limited partnership. The Tax Court examined several sources describing the characteristics of a limited partnership. It observed that the most common were limited liability and lack of control over the business. In this case, the PLLC was member-managed, such that each attorney had power over the business. The Tax Court also pointed out that the PLLC lacked a written Operating Agreement or any other evidence of limitations on control. Moreover, all members actually participated in control by supervising associate attorneys and making decisions about distributive shares, borrowing money, personnel, etc. The Tax Court underscored that the PLLC did not have at least one general partner, which is a requirement for a limited partnership. For these reasons, the Tax Court determined that the taxpayers were not limited partners for purposes of Section 1402(a)(13).

The Department also references Chief Counsel Advice 201436409, which involves a partnership acting as an investment manager to various funds ("Management Company").[62] The Management Company controlled the business of various investment funds, conducted market research, and implemented trading activity. The Management Company's primary source of income was management fees paid by the funds. Several individuals were partners in Management Company. They worked on a full-time basis, providing a wide range of investment-related services. The Management Company bifurcated payments to the partners, classifying some as guaranteed payments and subjecting them to SECA tax, while labeling the majority as distributions to limited partners exempt from such tax. The Management Company reasoned that it played the same role as the S corporation that it had succeeded, such that it was entitled to continue utilizing the "reasonable compensation" principles applicable to subchapter S corporations. The IRS explained that Section 1402(a)(13) was enacted in 1977 before modern business forms were common, suggested that the Revised Uniform Limited Partnership Act indicates that a limited partner loses his status if he participates in control of the business, and summarized the Tax Court's holdings in *Renkemeyer* and other cases. The IRS then turned to the facts at hand. It indicated that the partners of the Management Company performed extensive services, as partners, and generated essentially all the income. Accordingly, such income was "not income which is basically of an investment nature

The Tax Court underscored that the PLLC did not have at least one general partner, which is a requirement for a limited partnership.

[51] 20 New York Codes, Rules and Regulations § 137.1.

[52] 20 New York Codes, Rules and Regulations § 137.6; 2022 Instructions for Form IT-204 (Partnership Return and Related Forms), pg. 1.

[53] New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-M-09(1)MCTMT, June 1, 2009, pg. 10.

[54] Brian J. Rebhun et al., "All Aboard: The Impact of the New York State MTA Payroll Tax on Alternative Investment Fund Managers," The Tax Adviser (2009).

[55] 2010 Instructions for Form MTA-6 (Metropolitan Commuter Transportation Mobility Tax Return for Self-Employed Individuals, including Partners).

[56] New York Tax Law § 801(a)(2).

[57] New York Tax Law § 801(e) (emphasis added); New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-M-09(1)MCTMT, June 1, 2009, pg. 5.

[58] Social Security Amendments of 1977, Public Law No. 95-216, Section 313(b); Section 1402(a)(13) (emphasis added).

[59] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011).

[60] *Castigliola v. Commissioner*, T.C. Memo 2017-62.

[61] *Ibid.*

[62] Chief Counsel Advice 201436409.

of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to Section 1402(a)(13)." The IRS also opined that distributions to the partners were not passive, even though they paid more than a nominal amount for their ownership interests in the Management Company. The IRS further indicated that taxpayers, like the Management Company, cannot unilaterally change the character of distributions by simply labeling a portion of them guaranteed payments. Finally, the IRS concluded that the Management Company was a partnership, not an S corporation, such that it could not rely on the "reasonable compensation" rules.[63]

Conclusion

The limited partner exception to net earnings from self-employment has been a crucial and controversial issue at the *federal* level for several decades given the SECA tax rate of 15.3 percent, the proliferation of entities treated as partnerships for tax purposes, the absence of regulations or other formal guidance from the IRS defining limited partner, and the scarcity of Tax Court precedent. The issue acquired yet greater significance when the IRS initiated a Compliance Campaign in 2018 and declared its intent to litigate aggressively limited partner cases. Now, New York has upped the ante even further by auditing and imposing the Mobility Tax on taxpayers engaged in business in the MCTD, using the *federal* definitions (or lack thereof) of "net earnings from self-employment" and "limited partner" as its foundation.

Some might have begrudgingly paid the Mobility Tax in the past, considering it an unjustified, yet relatively minor, money grab by the Department. Many taxpayers doing business in New York have come to realize, though, that a reluctant concession with the Department regarding the limited partner exception might come back to haunt them later with the IRS. Specifically, they understand that the IRS likely would attempt to use an agreement between a partnership and the Department about the applicability of a *small* Mobility Tax (of just .0034 percent only on income from sources within the MCTD) as an admission regarding a *large* SECA tax (of 15.3 percent on all net earnings from self-employment). The inverse could occur, too, with the Department claiming that any loss before the Tax Court or settlement with the IRS constitutes an acknowledgement of liability for the Mobility Tax. Under these circumstances, taxpayers currently benefitting from the limited partner exception should understand the overlapping issues and stay abreast of the evolving federal and state battles. ■

[63] In addition to the federal sources described above, the Department sometimes cites to its own rulings involving partnerships and the Mobility Tax. *See* New York State Department of Taxation and Finance, Office of Tax Policy Analysis, Taxpayer Guidance Division, Metropolitan Commuter Transportation Mobility Tax, TSB-A-10(2) MCTMT, Oct. 28, 2010. In that case, a partnership formed in New York with two individual partners sought guidance from the Department regarding the applicability of the Mobility Tax to its situation. The partnership, an antiques business, had no store, no employees, and no separate office in New York. Its connections with New York consisted of the two partners residing in the state, storing merchandise in their home, and keeping the books and records in their home. The partners did not exhibit or sell merchandise from home; instead, they traveled to several antique shows around the country, rented space, made sales, and complied with local tax obligations. In any given year, the partners might not attend a show, and thus might not make any sales, in New York. The Department explained that, as partners in the partnership, they were self-employed individuals. It then held that the partnership was carrying on business activity in the MCTD because inventory and financial records were kept in the MCTD, and "direction and control" of the business activities occurs in the MCTD. Finally, since a portion of the net earnings from self-employment was attributable to other states, the Department indicated that the partnership could allocate such income appropriately.