

Prop. Reg. 1.1402(a)-2(h)(3)

Computation of net earnings from self-employment

(d)

Except as otherwise provided in section 1402(a) and paragraph (g) of this section, an individual's net earnings from self-employment include the individual'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 each partnership of which the individual is a partner.

(f)

For rules governing the classification of an organization as a partnership or otherwise, see §§301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

(g) Distributive share of limited partner. An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.

(h) Definition of limited partner.

(1) In general. Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.

(2) Limited partner. An individual is treated as a limited partner under this paragraph (h)(2) unless the individual-

(i) Has personal liability (as defined in §301.7701-3(b)(2)(ii) of this chapter 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.

(3) Exception for holders of more than one class of interest. An individual holding more than one class of interest in the partnership who is not treated as a limited partner under



paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest-

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

(4)Exception for holders of only one class of interest. An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest-

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

(ii) The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

(5)Exception for service partners in service partnerships. An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

(6)Additional definitions. Solely for purposes of this paragraph (h)-

(i) A class of interest is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A service partner is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii) A service partnership is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv) A substantial interest in a class of interest is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

(i) Example. The following example illustrates the principles of paragraphs (g) and (h) of this section:

Example.

(i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute \$1x for one LLC unit. B contributes \$2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of \$6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of \$10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) Application of general rule of paragraph (h)(2) of this section. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section. B's guaranteed payment of \$6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participate in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) Distributive share included in net earnings from self-employment. C's guaranteed payment of \$10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited

partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

(j)Effective date. Paragraphs (d), (e), (f), (g), (h), and (i) are applicable beginning with the individual's first taxable year beginning on or after the date this section is published as a final regulation in the Federal Register.