Estate of William J. Ellsasser, Deceased, William Ward Ellsasser, and Robert V. Schnabel, Executors and Charlotte C. Ellsasser, Petitioners v. Commissioner of Internal Revenue, Respondent, 61 T. C. 241 (1973)

A limited partner's distributive share of partnership income constitutes "net earnings from self-employment" subject to self-employment tax, even if the partner does not actively participate in the business.

Summary

In Estate of Ellsasser v. Commissioner, the United States Tax Court held that a limited partner's distributive share of partnership income is considered "net earnings from self-employment" under Section 1402(a) of the Internal Revenue Code of 1954, thus subjecting it to self-employment tax. William J. Ellsasser, a limited partner in a stock brokerage partnership, received income without participating in the business. The court's decision was based on the statutory definition, legislative history, and regulations, all of which indicated that Congress intended to include limited partners' distributive shares as self-employment income, regardless of their level of activity in the partnership.

Facts

William J. Ellsasser was a limited partner in Sade & Co. , a stock brokerage partnership, from 1961 until his death in 1970. He did not participate in the management or operations of the partnership, nor did he provide any services. Ellsasser's distributive share of the partnership's income was $13,521. 24 in 1967 and $12,433. 63 in 1968. He and his wife reported these amounts as other income on their joint federal income tax returns for those years but did not include them in calculating their self-employment tax liability. The Commissioner of Internal Revenue assessed deficiencies in self-employment tax for both years, asserting that Ellsasser's distributive share should be treated as self-employment income.

Procedural History

The case was initially filed with the United States Tax Court, where the Commissioner determined deficiencies in Ellsasser's income tax for the years 1967 and 1968 due to the inclusion of his distributive share of partnership income as self-employment income. The petitioners contested this determination, arguing that Ellsasser's passive income should not be subject to self-employment tax. The Tax Court, after reviewing the case, upheld the Commissioner's determination.

Issue(s)

1. Whether the distributive share of partnership income allocable to a limited partner who contributes no services to the business of the partnership constitutes "net earnings from self-employment" under Section 1402(a) of the Internal Revenue Code of 1954.

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Holding

1. Yes, because the statutory definition, legislative history, and applicable regulations clearly indicate that Congress intended for a limited partner's distributive share of partnership income to be included in "net earnings from self-employment," subject to self-employment tax.

Court's Reasoning

The Tax Court's decision hinged on the interpretation of "net earnings from self-employment" as defined in Section 1402(a) of the Internal Revenue Code. The court noted that this term encompasses both an individual's income from their own trade or business and their distributive share of income from a partnership's trade or business. The court emphasized that the level of personal activity in the partnership is irrelevant to the qualification of partnership income as self-employment earnings. The legislative history from the 1950 Social Security Act Amendments and subsequent amendments in 1967 further supported the court's interpretation, explicitly stating that a limited partner's distributive share is to be included. Additionally, the court found the applicable Treasury regulations to be consistent with the legislative intent. The court also referenced case law under the Social Security Act, which supported the inclusion of a limited partner's income in self-employment earnings. The court rejected the petitioners' arguments that Ellsasser's interest should be treated similarly to that of a stockholder or passive investor, as Congress had specifically classified partnerships differently.

Practical Implications

This decision has significant implications for limited partners and tax practitioners. It clarifies that limited partners must include their distributive share of partnership income in calculating their self-employment tax, regardless of their level of involvement in the partnership's business. This ruling affects the tax planning strategies for individuals investing in partnerships, particularly in sectors like finance and real estate, where limited partnerships are common. It also underscores the importance of understanding the statutory definitions and legislative intent behind tax provisions. Subsequent cases have generally followed this precedent, though legislative changes or further judicial interpretations could alter the treatment of limited partners' income in the future.

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