Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:TEGE:EOEG:ET1-PLR-110459-03

Date:

September 29, 2003

LEGEND: Firm =

Dear Firm:

This is in reply to your request for a ruling concerning whether payments made under a retirement plan maintained by the Firm for retired partners satisfies the requirements of Internal Revenue Code section1402(a)(10), and are, therefore, excludible from gross income when determining net earnings from self-employment.

The Firm is a professional limited liability partnership engaged in the practice of law. The Firm is classified as a partnership for federal income tax purposes. The members of the Firm are treated as partners for federal income tax purposes, and are hereafter referred to as partners. The Firm files income tax returns based upon a calendar year. All partners in the Firm are individuals and are calendar year taxpayers.

The Firm maintains an unfunded retirement benefit program (the "Retirement Program") for its partners that provides for payments directly from the Firm to retired partners. The Retirement Program is set forth in the partnership agreement governing the operations of the Firm.

Under the Retirement Program, a partner may elect to retire at any time after reaching age 60. If a partner retires prior to age 60, unless the partner has 25 years of service with the Firm at the time of retirement, benefits will commence to be paid in the year the retired partner attains age 60. If a partner has 25 years of service with the Firm at the time of retirement, the earliest time at which the payment of benefits would commence would be the year in which the partner attains age 55. To be entitled to any benefit under the Retirement Program a partner must have at least 5 years of service with the Firm.

For purposes of the Retirement Program, partners of the Firm are divided into two classes, general partners and special partners. A general partner has an interest in the

net earnings of the Firm and is eligible for additional amounts awarded at the discretion of the Firm. A special partner receives a guaranteed payment and is eligible for additional compensation awarded at the discretion of the Firm. Each retiring general partner is entitled to 150 percent of the partner's highest annual calendar year compensation during the final four years of service as a partner at the Firm. Each retiring special partner is entitled to 100 percent of the partner's average annual calendar year compensation during the final five calendar years of service as a partner at the Firm. If a retiring general partner or special partner does not reach a certain minimum number of years of service with the Firm, the Retirement Program provides for a reduction in the retirement payments.

Payments under the Retirement Program are made in five annual installments. The first installment is payable within 90 days after the first day of the "payment commencement year" for the retired partner, with the remaining four installment payments being made within 90 days after the first day of the next four calendar years. For a general partner, the payment commencement year is the later of the second calendar year following the calendar year in which the retirement date for the general partner occurs, or the calendar year in which the general partner attains age 60. However, if the general partner has 25 or more years of service with the Firm, the relevant calendar year will be the year in which the general partner attains age 55. For a special partner, the payment commencement year is the later of calendar year following the calendar year in which the retirement date for the special partner occurs, or the calendar year in which the special partner attains age 60. However, if the partner has 25 years or more of service with the Firm, the relevant calendar year will be the year in which the special partner attains age 55.

A retired partner receives all compensation due for the year the partner retires by March 15 of the following calendar year. The retired partner's capital account in the Firm is distributed to the partner prior to March 31 of the following calendar year. Thus, both compensation due and the retired partners' capital account will be distributed during the calendar year preceding the commencement of retirement payments for a general partner and by the end of March in the calendar year in which retirement payments commence for special partners.

The initial retirement payments are paid out in five annual installments. After this series of annual payments is completed, and provided the retired partner is still living, the retired partner is entitled to payments of \$100 per month for the rest of the retired partner's life.

In addition to the retirement payments under the Retirement Program for retired partners, the Firm has another program pursuant to which a retired partner may be entitled to additional amounts from the Firm after the partner has received the final distribution of partnership income for the year of retirement and the partner's capital account has been distributed. Investments are made under the Firm's investment program from after-tax funds of the partners. A partner retiring or leaving the Firm may continue to have an interest in investments made under the program. However, a

retired partner is not entitled to any voting rights or other rights with respect to the Firm. The only right a retired partner has is to receive distributions from the investment program, if and when made to all partners and terminated partners with similar entitlements. The Firm will amend the partnership agreement to provide a retiring partner with two options under the investment program. A retiring partner may elect either (1) to have the partner's investment in the Firm's investment program valued and paid to the partner before the close of the Firm's taxable year, or (2) the partner may elect to continue to have an interest in the Firm's investment program. The Firm states that if a retired partner elects the second option, all payments made by the Firm to the retired partner during the year will not be treated by the Firm or the retired partner as excluded from "net earnings from self-employment" under section 1402(a)(10).

In general, a partner will not render any services to the Firm following the partner's retirement from the Firm. However, in rare cases a retired partner will enter into an "of counsel" relationship with the Firm pursuant to which the retired partner performs occasional services for the Firm in exchange for agreed compensation. The Firm states that all payments made to a retired partner during a year with respect to which compensation is being received under the "of counsel" arrangement would not be treated by the Firm or the retired partner as excluded from "net earnings from self-employment" under section 1402(a)(10).

Section 1401 imposes a tax on the self-employment income of every individual. Section 1402(b) defines "self-employment income" as the "net earnings from self-employment" derived by the individual, subject to certain conditions and limitations.

Section 1402(a), in defining the term "net earnings from self-employment," specifically excludes retirement payments to a partner if the requirements in section 1402(a)(10) and the regulations thereunder are met.

Section 1402(a)(10) and section 1.1402(a)-17 of the Income Tax Regulations provide that such retirement payments are excluded from "net earnings from self-employment" if:

- (1) the payments are made on a periodic basis by a partnership pursuant to a written plan that provides for payments on account of retirement to partners generally or to a class or classes of partners to continue at least until the partner's death (to qualify as payments on account of retirement, the payments must constitute bona fide retirement income; generally, retirement benefits are measured by, and based on, such factors as years of service and compensation received);
- the retired partner to whom the payments are made rendered no service with respect to any trade or business carried on by the partnership (or its successors) during the taxable year of the partnership (or its successors), which ends within or with the taxable year of the partner and in which the payment was received;

- (3) no obligation exists (as of the close of the partnership year referred to in (2) above) from the other partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and
- (4) the retired partner's share of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in (2) above.

Regulation section 1.1402(a)-17 provides that by operations of the conditions set forth in the above subparagraphs either all payments on account of retirement received by a retired partner during the taxable year of the partnership ending within or with the taxable year of the partnership are excluded or none of the payments are excluded. The regulations further provides that the effects of the conditions set forth in (3) and (4) above is that the exclusion may apply with respect to such payments received by the retired partner during the taxable year only if at the close of the partnership taxable year the retired partner has no financial interest in the partnership except for the right to retirement payments.

On the basis of the facts presented, the Firm's Retirement Program would be considered a bona fide retirement plan, within the meaning of section 1402(a)(10). The Retirement Program provides for payment to each retiring partner on the basis of the partner's age, physical condition and years of service; or a combination of age and physical condition and years of service. Although the payments by the Firm are likely to be reduced after the initial annual payments, once the annual payments conclude, monthly payments that never fall below \$100 per month will continue until the retired partner's death.

Additionally, except for payments made to a partner providing services as "of counsel" and a partner electing to continue participation in the investment arrangements, the facts establish that payments made to retired partners from the Retirement Program meets the conditions for exclusion under regulation section 1.1402(a)-17(c)(i) and (ii). The retired partner will withdraw his entire capital account by the end of the taxable year of the Firm in which the payments commence and the Firm will also distribute the entire value of the retired partner's interest in the Firm's investment program by the end of the taxable year in which retirement payments commence. Thus, neither the Firm nor the other partners will have any obligations to the retired partner other than the retirement payments under the Retirement Program.

Therefore, retirement payments made by the Firm under the Retirement Program to a retired partner will be excluded from "net earnings from self- employment" by section 1402(a)(10) if (1) the retired partner renders no service during the taxable year of the Firm which ends within or with the taxable year of the partner and in which the payment is received, (2) at the close of that taxable year of the Firm, no obligation exists from the partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and (3) at the close of that taxable year of

the Firm, the retired partner's share of the capital of the Firm has been paid to him in full.

However, in any year when a retired partner renders service to the Firm as "of counsel" and/or continues to participate in the Firm's investment program, the retired partner will not satisfy section 1.1402(a)-17(c), and all payments received by such retired partner during the taxable year of the Firm ending within or with the retired partner's taxable year are not excludible from net earnings from self-employment under section 1402(a)(10).

No opinion is expressed as to the income tax consequences to the participants, the Firm or the other partners, of participation in the Retirement Program. Specifically, no opinion is expressed as to the amount or timing of any recognition of income or deductions due to participation in or sponsorship of the Retirement Program, the application of sections 83, 402 or 451, or the doctrines of constructive receipt or economic benefit. Accordingly, no opinion is expressed as to the amount or timing of any recognition of self-employment income under section 1402. Rather, this ruling addresses only whether, to the extent any self-employment income would otherwise be recognized by a participant in the Retirement Program, section 1402 would operate to exclude such income from self-employment income.

Furthermore, no opinion is expressed as to the treatment of the payments to the retired partners under Subtitle A, Chapter 1, Subchapter K of the Code and under other provisions of Subtitle A, Chapter 2 of the Code, except for section 1402(a)(10) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Will E. McLeod Chief, Employment Tax Branch 1 Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)