

Minimizing Self-Employment Taxes For LLC Members

Limited Liability Companies (LLC) have become the entity of choice for business owners. LLC members are afforded limited liability protection under state law as well as the flexibility to be taxed as a disregarded entity, partnership, or a C- or S-corporation under federal tax law, depending on the number of members. LLCs also provide better creditor protection than a corporation under state law. Practitioners, however, often cite the ability to minimize an S-corporation's shareholder-employee's employment taxes¹ as an advantage of an S-corporation over an LLC.

Employment taxes are imposed on an S-corporation's shareholder-employee's wages, but not on a shareholder's distributive share.² Self-employment taxes³ are imposed on a person's net earnings from self-employment income, unless the self-employment income is attributable to the person's status as a limited partner.⁴ A limited partner's distributive share is generally not subject to self-employment taxes.⁵ Guaranteed payments, whether made to a partner or a member, which are akin to salary, are always subject to self-employment taxes.⁶ Presumably, members of an LLC taxed as a partnership are subject to self-employment taxes on their distributive share, unless they are treated as a limited partner. Determining if an LLC member's distributive share is subject to self-employment taxes is a difficult process because there is limited guidance for a practitioner. In an attempt to bring clarity to this uncertainty, on December 29, 1994, the Department of the Treasury issued proposed regulations (the 1994 Proposed Regulations) addressing whether an LLC member will be treated as a limited partner whose distributive share is not subject to self-employment taxes.⁷

The 1994 Proposed Regulations were withdrawn on January 13, 1997 because of negative practitioner comments and revised proposed regulations were issued (the 1997 Proposed

Regulations). The Department of the Treasury never issued the 1997 Proposed Regulations in final form;⁸ however, they are effective as proposed regulations. The 1997 Proposed Regulations provide guidance in determining whether a member is treated as a limited partner whose distributive share is not subject to self-employment taxes. The IRS is bound by a proposed regulation if a taxpayer reasonably relies on it.⁹ In addition, proposed regulations can be relied on to avoid taxpayer and preparer penalties.¹⁰

The 1997 Proposed Regulations set forth a three-part functional test (the functional limited partner test) to determine whether a member is a limited partner for self-employment tax purposes (a functional limited partner). Under the 1997 Proposed Regulations, an individual generally is treated as a limited partner unless:

1. The individual has personal liability for the debts of the partnership by virtue of being a partner;¹¹
2. The individual has authority under local law to contract on behalf of the partnership;¹² or
3. The individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.¹³

If a member is a functional limited partner, such member's distributive share is not subject to self-employment tax.¹⁴

LLCs are typically member-managed or manager-managed. The type of LLC management is critical in determining whether a member's distributive share is subject to self-employment taxes. No member of a member-managed LLC can be treated as a limited partner because of each member's statutory authority to bind the LLC. Most LLC statutes vest authority to bind a manager-managed LLC solely in the manager.¹⁵

(continued)

1 Under the Federal Insurance Contributions Act, employment taxes consist of a 12.4% Old-Age, Survivors, and Disability Insurance (OASDI) tax rate and a 2.9% Hospital Insurance (HI) tax rate on wages. IRC §3111; IRC §3101. For 2011 the 12.4% OASDI tax rate has been reduced to 10.4% and is imposed on the first \$106,800 of wages. The 2.9% HI tax is imposed on all wages.

2 S corporation shareholder is subject to employment taxes on reasonable compensation for services rendered. Rev. Rul. 59-221.

3 Under the Self-Employment Contributions Act, the self-employment tax consists of a 12.4% OASDI tax rate and a 2.9% HI tax rate on net earnings from self-employment income. IRC §1401. For 2011 the 12.4% OASDI tax rate has been reduced to 10.4% and is imposed on the first \$106,800 of self-employment income. The 2.9% HI tax is imposed on the entire self-employment income amount.

4 IRC §1401; IRC §1402.

5 IRC §1402(a)(13).

6 Treas. Reg. §1.1402(a)-1(b); Prop. Reg. §1.1402(a)-2(g).

7 59 Fed. Reg. 67,253 (December 29, 1994).

8 Prop. Reg. §1401(a)-2 is applicable beginning with the individual's first taxable year beginning on or after the date it is published as a final regulation in the Federal Register.

9 *Elkins v. Comm'r*, 81 T.C. 669 (1983).

10 *U.S. v. Boyle*, 469 U.S. 241 (1985); Treas. Reg. §1.6662-4(d)(3)(iii).

11 Prop. Reg. § 1.1402(a)-2(h)(2)(i).

12 Prop. Reg. § 1.1402(a)-2(h)(2)(ii).

13 Prop. Reg. § 1.1402(a)-2(h)(2)(iii).

14 Prop. Reg. §1.1402(a)-2(g).

15 See M.G.L. ch. 156C, § 24 (management and control of a manager-managed LLC vests in the Manager and no member shall have the authority to manage and control the LLC); Compare with, Del. Code Ann. tit. 6, §18-402 (ambiguous as to whether authority to bind and contract on behalf of the LLC solely vests in the manager of a manager-managed LLC).

Under the 1997 Proposed Regulations, there is a presumption that a member is a limited partner, unless the member fails the functional limited partner test.¹⁶ If a member fails the functional limited partner test, there are still two exceptions that allow such a member to be treated as limited partners.

1. The Multiple Class Exception. A member that fails the functional limited partner test may still be treated as a limited partner if: 1) members who are functional limited partners own a substantial, continuing interest in a specific class of interest held by the non-functional limited partners; and 2) the non-functional limited partner's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of the specific class of interest that the functional limited partners hold.¹⁷ Members owning more than 20 percent of a class satisfy the substantial interest component of the test.¹⁸

2. The Material Participation Exception. A member who participates in the LLC's business for more than 500 hours is not treated as a functional limited partner because of the 500 hour participation restriction. A member who is not treated as a functional limited partner solely because such member participates in the LLC's business for more than 500 hours will be treated as a limited partner if: 1) there are other members that satisfy the functional limited partner test; 2) the functional limited partners own a substantial, continuing interest in the functional limited partner interest; and 3) the member's rights and obligations are identical to the rights and obligations of the class of interest held by the functional limited partners in the same class.¹⁹

The 1997 Proposed Regulations provide the following illustration of a manager- managed LLC:

1. Facts. A, B and C form XYZ, LLC, a manager-managed limited liability company, under the laws of state to engage in a business that is not a service partnership. XYZ, LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit: 25 percent to A, 50 percent to B and 25 percent to C. A and C each receive one LLC unit for \$5. B receives two LLC units for \$10. A does not perform services for XYZ, LLC. B receives a guaranteed payment for 600 hours of services rendered to XYZ, LLC, and C receives a guaranteed payment for 1,000 hours of services rendered to XYZ, LLC. C also is elected XYZ, LLC's, manager. Under state's law, C has the authority to contract on behalf of LLC.

2. Application of Functional Limited Partner Test. A is treated as a functional limited partner in XYZ, LLC, under the functional limited partner test because: 1) A is not liable personally for debts of or claims against XYZ, LLC; 2) A does

not have authority to contract for XYZ, LLC, under state's law; and 3) A does not provide services for more than 500 hours to XYZ, LLC. A's distributive share attributable to A's 25 percent LLC unit is excluded from A's net earnings from self-employment.

3. Application of Material Participation Exception. B's guaranteed payment is included in B's net earnings from self-employment. B is not treated as a functional limited partner because, although B is not liable for debts of, or claims against, XYZ, LLC, and B does not have authority to contract for XYZ, LLC, under state's law, B provides services to XYZ, LLC, for more than 500 hours. Further, B is not treated as a limited partner under the multiple class exception because XYZ, LLC, issued only one class of interest. B is treated as a limited partner under the material participation exception because B is not a functional limited partner under the functional limited partner test solely because: 1) B provides services for more than 500 hours; and 2) A is a functional limited partner who owns a substantial, continuing interest with rights and obligations that are identical to B's rights and obligations. B's distributive share attributable to B's 50 percent LLC units is not net earnings from self-employment.

4. Distributive Share Included in Net Earnings From Self-Employment. C's guaranteed payment is included in C's net earnings from self-employment. In addition, C's distributive share attributable to C's 25 percent LLC interest also is net earnings from self-employment because C is not a limited partner under: 1) the functional limited partner test; 2) the multiple class exception; or 3) the material participation exception. C is not treated as a functional limited partner because C has the authority under state's law to enter into a binding contract on behalf of XYZ, LLC, C provides services to XYZ, LLC, for more than 500 hours, and C is not treated as a limited partner under the multiple class exception because C does not hold more than one class of interest. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment.

To reduce C's self-employment tax exposure in XYZ, LLC, the members could bifurcate XYZ, LLC's, interests into two classes. Under the multiple class exception, a member that fails the functional limited partner test may be treated as a limited partner if: 1) members who are functional limited partners own a substantial, continuing interest in a specific class of interest held by the non-functional limited partners; and 2) the non-functional limited partner's rights and obligations, with respect to that specific class of interest, are identical to the rights and obligations of that specific class of interest that the functional limited partners hold.

¹⁶ A service partner in a service partnership may not be a limited partner under Prop. Reg. §1.1402(a)-2. Prop. Reg. §1.1402(a)-2(h)(5).

¹⁷ Prop. Reg. §1.1401(a)-2(h)(3).

¹⁸ Prop. Reg. §1.1402(a)-2(h)(6)

¹⁹ Prop. Reg. §1.1402(a)-2(h)(4)

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