Self-Employment Taxes on Flow-Through Earnings: The S-Corporation vs. LLC or Limited Partnership

By Dennis F. Gorman, Esq., CPA

The tax law governing the imposition of self-employment taxes on the flow-through income of S-corporations and LLC's/limited partnerships continues to evolve. Historically, net earnings from self-employment have included net income derived by an individual from his/her trade or business, an individual's distributive share of a partnership's trade or business net income, and guaranteed payments to a partnership member (determined without regard to the partnership's income). The distributive share of S-corporation net income is not currently subject to self-employment taxes.

This has affected the choice of entity decision-making process for some practitioners (myself excluded). LLC's afford many benefits over S-corporations, which make them the entity of choice.

Prior to 1958, businesses operated as sole proprietorships (individual level tax-liability issues); C-corporations (corporation and individual level taxes) or partnerships (individual level taxes – liability issues). Historically, partnerships were primarily service type businesses and corporations were capital oriented. Over the years, Congress has reduced and/or eliminated categories of earnings that were exempt from self-employment taxes. Partnership K-1 earnings have long been subject to self-employment taxes with exceptions, e.g., limited partners or real estate investment income.

When S-corporations arrived on the scene in 1958, Congress did not broaden the definition of taxable self-employment earnings to include S-corporation K-1 earnings. This has created a distinction without meaning between partnerships and S-corporations in this area. The IRS has recently begun auditing S-corporations to ensure that its shareholders have paid themselves reasonable self-employment taxable wages. In some cases, the IRS has recast otherwise non-taxable S-corporation distributions as self employment taxable wages.

The courts have begun to uphold these IRS reclassifications. Congress and IRS have been at odds for years regarding the self-employment taxability of partnership earnings. The IRS recently issued regulations attempting to create a clearer bright line standard. Generally, general partners of partnerships have been taxed on their partnership earnings and limited partners have not. For LLC's, managers of manager-managed LLC's are taxable and all members (with contractual authority) of a member managed LLC are taxed on their earnings.

Under some 1997 proposed IRS regulations, it is possible to use two classes of LLC shares in order to minimize the impact of self-employment taxes on member's earnings.

In turn, Congress has introduced legislation which would impose (at the shareholder level) self-employment taxes on a professional service S-corporation's earnings. Thus, it would appear that Congress, the courts and the IRS are moving to a logical common ground regarding self-employment taxes. Namely, that the net distributive flow-through earnings of S-corporations, LLC's and partnerships may be subject to self-employment taxes to the extent the earnings are reasonably attributed to services rendered by the owner. Flow-through entity earnings over and above reasonable compensation should logically not be subject to self-employment taxes. Whether the law evolves to this rational standard remains to be seen. Stay tuned!

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