

Minimizing Self-Employment Tax of LLC Managing Members

By Janet Meade

Although a limited liability company (LLC) is rapidly becoming the entity of choice for most new closely held businesses, the self-employment (SE) tax treatment of LLC members, who are classified as "partners" for federal income tax purposes, remains ambiguous. Largely because of this ambiguity, many advisors are hesitant to recommend using LLCs, opting instead for S corporations. But contrary to widespread belief, S corporations do not necessarily enjoy an automatic advantage over LLCs in the SE tax realm.

Self-Employment Tax

The SE tax is an additional tax of 15.3% that is levied on an individual's SE income in excess of \$400. Generally, SE income includes income derived from any trade or business carried on by an individual, plus the distributive share of income or loss from any trade or business conducted by a partnership of which the individual is a partner under the tax law. Certain types of income, including real estate rentals, dividends, interest, and capital gains, are not necessarily considered SE income. In addition, SE income does not generally include most of an individual's earnings attributable to limited partnership interests, other than guaranteed payments for services. The rationale behind this treatment is that general partners derive their income from the performance of services, while limited partners derive their income from capital.

The different treatment of general and limited partners in certain circumstances allows a partner in a limited partnership

to bifurcate partnership distributions. Guaranteed payments and income allocable to a partner's general partnership interest are classified as SE income and are subject to SE tax, while income allocable to a partner's limited partnership interest is

ilar SE tax treatment on their distributive shares of income or loss.

In contrast to the well-defined rules governing partners and S corporation shareholders, the SE tax treatment of members of an LLC classified as a partnership for federal tax purposes is ambiguous. Many practitioners assume that the SE tax treatment of a managing member of an LLC is the same as that of a general partner in a partnership, and that non-managing members are treated the same as limited partners. Thus, they classify all of a managing member's earnings and distributive income as subject to SE tax, while excluding the distributive income of the nonmanaging members from the tax.

Proposed Treasury Regulations Section 1.1402(a)-2

The premise for this SE tax treatment stems from Proposed Treasury Regulations section 1.1402(a)-2(h)(2), which effectively equalizes the positions of limited

partners and certain LLC members who are not managers by treating partners or members of an LLC as limited partners unless they meet one of the following tests:

- They have personal liability for debts or claims against the partnership;
- They have authority to contract on behalf of the partnership; or
- They participate in the partnership's trade or business for more than 500 hours during the partnership's tax year.

The 500-hour test is modified for LLCs engaged in professional services, such as medicine, law, engineering, architecture, accounting, actuarial science, or consulting. For those entities, no member who provides more than some de minimis amount of services to the LLC can

not. A partner who receives both income based on services rendered to the partnership and income derived from capital invested in the partnership may consequently be allowed to have only the service income subject to SE tax.

When the allocations are reasonable, an S corporation shareholder is allowed a similar bifurcation of income because the SE income of such a shareholder includes only amounts received as compensation for services rendered to the S corporation. Thus, payments of salary, bonuses, and professional fees are subject to SE tax, while other items of income or loss that automatically pass through to the shareholder from the S corporation avoid taxation. Both an S corporation shareholder and a limited partner consequently may receive sim-

ilar SE tax treatment on their distributive shares of income or loss.

In contrast to the well-defined rules governing partners and S corporation shareholders, the SE tax treatment of members of an LLC classified as a partnership for federal tax purposes is ambiguous. Many practitioners assume that the SE tax treatment of a managing member of an LLC is the same as that of a general partner in a partnership, and that non-managing members are treated the same as limited partners. Thus, they classify all of a managing member's earnings and distributive income as subject to SE tax, while excluding the distributive income of the nonmanaging members from the tax.



qualify for treatment as a limited partner for SE tax purposes.

Proposed Treasury Regulations section 1.1402(a)-2 was originally issued by the IRS in 1997. However, because of controversy over the SE tax treatment of limited partners who are active in a partnership's business, Congress prohibited the IRS from making the regulations final before July 1, 1998, believing instead that Congress should formulate such rules. Since the expiration of the moratorium, neither Congress nor the IRS has acted to clarify the SE tax treatment of LLC members, leaving the proposed regulations as the only administrative guidance on the matter. Thus, while the proposed regulations are not entitled to judicial deference, because they do not represent a legal position, they can be relied on to avoid a penalty under IRC section 6406(f), and there is judicial precedence, in *Elkins* [81 T.C. 669 (1983)], to reasonably conclude that the courts will sustain the position of a taxpayer who relies on proposed regulations.

Given the historical significance of proposed Treasury Regulations section 1.1402(a)-2, the strategies below have been proposed as ways to minimize the SE tax of an LLC member. While none of these strategies are effective for LLC members engaged in one of the seven professions listed above, they can be used by members of other LLCs.

Bifurcation of a Member's Interest

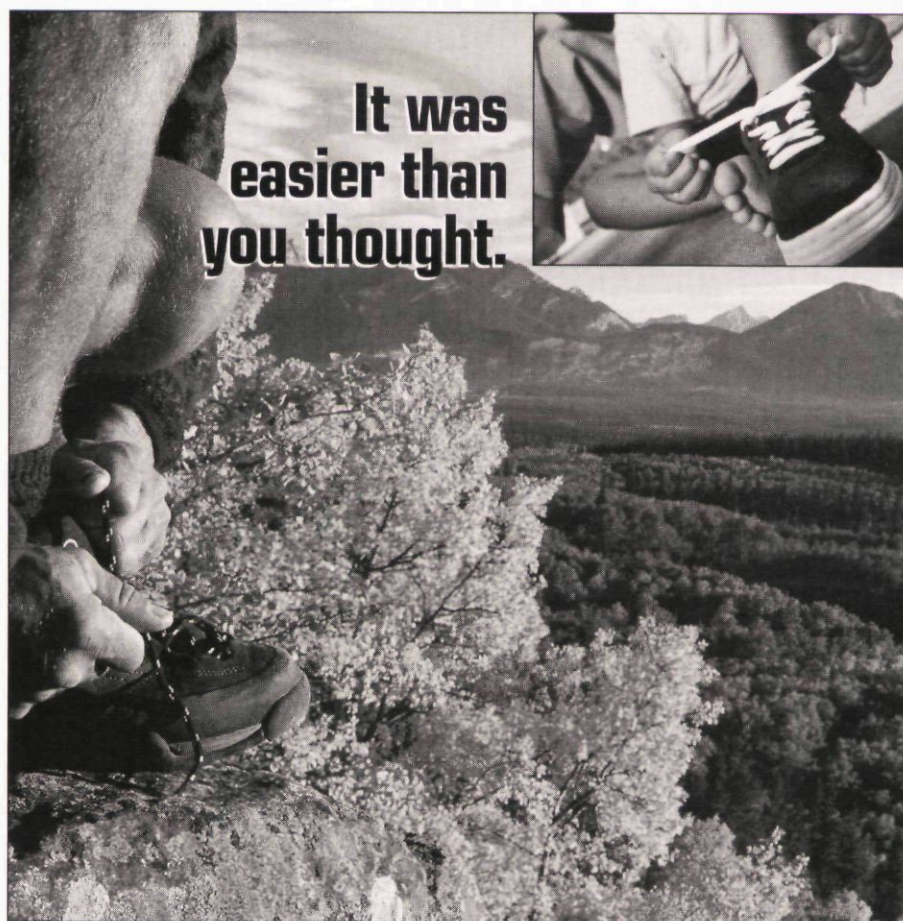
If an LLC member fails the limited partner test because that member participates in a nonprofessional LLC for more than 500 hours during the tax year, Proposed Treasury Regulations section 1.1402(a)-2(h)(4) allows that member to be taxed as a limited partner for SE tax purposes if she owns only one class of interest and if, immediately after acquiring the interest, the member has rights and obligations identical to those of the other members who are already classified as limited partners and who own a substantial (i.e., at least 20%) continuing interest in that class of interest.

In addition, Proposed Treasury Regulations section 1.1402(a)-2(h)(3) allows an LLC member of a nonprofessional LLC who fails one or more of the limited partner tests, but who holds more than one class of interest, to be treated as a limited partner with respect to a partic-

ular class of interest if, immediately after acquiring the interest, the member has rights and obligations identical to those of the other members who are already classified as limited partners and who own a substantial (i.e., at least 20%) continuing interest in that class of interest.

Because application of the SE tax to LLC members under the proposed regulations

depends not only upon their formal status as members or managing-members but also on their level of participation in the entity, strategies for minimizing an LLC member's SE tax exposure generally involve the governing provisions of the LLC. This is because issues such as the designation of a manager and the extent of authority given to nonmanaging members, while funda-



And so is data mining with IDEA.



IDEA

Data Analysis Software

IDEA is a registered trademark of CaseWare International, Inc.

With IDEA, joining data is as easy as tying your shoe.

IDEA also quickly and accurately extracts, imports, analyzes and samples data from almost any source. Learning this powerful, easy to use, productivity tool is a walk in the park. And, one free year of customer support helps remove any stumbling blocks. For a free demo, hike over to our web site at www.audimation.com.

mentally business considerations, have significant tax implications.

The proposed regulations specifically allow bifurcation of an LLC member's distributive share of income in situations where the member holds dual classes of interest, one of which is the same as nonmanaging members. Furthermore, the proposed regulations seem to sanction a nominal amount of income attributable to a general-partner interest as long as a reasonable guaranteed payment is made for services rendered to, or on behalf of, the LLC. One strategy for SE tax reduction is to issue two classes of interest, a managing interest and an investment interest, to the same individual.

Example

M and N form an LLC with managing interests and investment interests. Holders of units in each class are entitled to one vote per unit on matters affecting the LLC. They are also entitled to share in the profits and losses of the LLC in proportion to their share of total contributions to the LLC. Only holders of the managing units, however, can contract on behalf of the LLC.

M purchases one managing unit and 69 investment units. N purchases 30 investment units. Under the operating agreement of the LLC, the managing member is to receive a guaranteed payment of \$30,000 for his services. At the end of the first year, the LLC has net profits of \$100,000, after deducting M's guaranteed payment. M would report \$31,000 as SE income (\$30,000 guaranteed payment plus 1% of \$100,000 for his one managing-member unit). The remaining distributive incomes of \$69,000 to M and \$30,000 to N are attributable to their investment units, and therefore would not be SE income.

For this strategy to succeed, several requirements must be met. First, the LLC must not provide professional services in medicine, law, engineering, architecture, accounting, actuarial science, or consulting. Second, at least one member other than the managing member must hold units representing a 20% investment ownership interest, and this member (or members) cannot hold a managing interest or participate in the management of the LLC. As such, this technique is not available to single-member LLCs or those assigning management responsibilities to all members.

Because the proposed regulations contain no family-attribution rules, however, the requirement for a 20% passive ownership interest could be satisfied by splitting ownership in the LLC between family members, provided that the overall allocation of income has a "substantial economic effect" and satisfies the requirements of IRC section 704(b). The same results would be obtained in the example above if M and N were husband and wife.

As an alternative for spouses as members of the LLC, children and other family members could be included. This strategy has the advantage of spreading income across tax rates when children or other family members are in lower tax brackets, such as for children not subject to application of the "kiddie" tax rules because they are at least 14 years old at the end of the tax year. As mentioned above, any allocation of income to the members of the LLC must have a "substantial economic effect" and satisfy the requirements of IRC section 704(b) for it to be respected by the IRS.

Prerequisites to Bifurcation

For an allocation of income to have a "substantial economic effect," the bifurcation must be driven by a significant investment business purpose. Generally, this requires that the allocation be consistent with the underlying economic arrangements of the members, and that the non-tax economic effect of the allocation be substantial. An allocation will be considered to have an economic effect if the LLC maintains its book capital accounts in accordance with IRC section 704(b), makes distributions in accordance with positive capital accounts, and requires LLC members to restore deficits in their capital accounts upon liquidation of their interest. The economic effect of the allocation will be considered substantial if a reasonable possibility exists that the allocation will significantly change the income to be received by the members from the LLC, independent of the tax consequences.

An additional prerequisite to bifurcating the managing member's share of distributive income from the LLC is that the managing member's guaranteed payments from the LLC must be high enough to be construed as reasonable for the services rendered. Although numerous court cases have established criteria for determining reasonable

compensation for employed S corporation shareholders, no comparable standards exist to determine the sufficiency of a guaranteed payment to an LLC managing member for similar services. The amount of the guaranteed payment must be set with care.

When it is not feasible to have the managing member hold dual interests in the LLC, the managing member's SE tax exposure can still be minimized by naming a manager who is not a member of the LLC. Many states allow outside managers, and when this strategy is adopted, none of the LLC members would be subject to SE tax on their distributive share of LLC income. The manager, however, must be compensated by the LLC for any services rendered and, as such, would be subject to SE tax on this compensation (unless it were an entity not subject to SE tax, such as a corporate affiliate of an LLC member). In this situation, however, the IRS might treat the use of a related-entity manager as a sham transaction unless the management services were provided at arm's length and with a reasonable business purpose.

Be Certain the Circumstances Are Right

These proposed bifurcation strategies are not without risk. Proposed Treasury Regulations section 1.1402(a)-2, upon which the strategies rely, was issued over eight years ago and never adopted. As such, it is not entitled to judicial deference. The IRS, however, has privately stated that until it issues further guidance in this area, it will not challenge LLC members on SE tax if the members and the LLC conform to the proposed regulations. Despite this assurance, the IRS could, and probably would, challenge any bifurcation of a managing member's income if it lacked a "substantial economic effect" or was made without regard to the reasonableness of the member's guaranteed payment. Thus, these bifurcation strategies are appropriate only in certain circumstances. But when those circumstances exist, bifurcation of an LLC managing member's income can create SE tax savings comparable to those of an S corporation. □

Janet Meade, CPA, PhD, is an associate professor in the C.T. Bauer College of Business at the University of Houston, Houston, Texas.