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"a properly structured LLC should not pose any more uncertainty regarding self-employment taxes than any other form of entity"

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Choice of Business Entity: Do Self-Employment Taxes Disfavor Limited Liability Companies?

Prior to 2007, many Texas based businesses conducted operations through a limited partnership because partnerships were not subject to Texas franchise tax. With the changes in the franchise tax law eliminating the tax favored status of partnerships, businesses are more likely to consider alternative legal entity forms. A limited liability company ("LLC") form offers several advantages over corporations (including S corporations) and partnerships. But one frequently cited drawback to an LLC is the uncertainty regarding whether LLC owners must pay self-employment tax on the entire earnings of the business rather than on just the amount representing reasonable compensation for their services for the business.


As discussed below, a properly structured LLC should not pose any more uncertainty regarding self-employment taxes than any other form of entity. Therefore, entrepreneurs need not shy away from using an LLC due to concerns about self-employment taxes.

BACKGROUND

Self-employment tax is imposed on income derived by an individual from any trade or business carried on by the individual, including the individual's distributive share of income from a trade or business carried on by a partnership of which the individual is a partner. Exceptions are provided for certain types of passive investment income, gains from capital assets, and other specified income and deductions. (For simplicity, the discussion below generally assumes the business does not generate any of these statutorily excluded items of income or deduction.)

In 1977, Congress learned that promoters were soliciting investments in limited partnerships as a means of gaming the social security system. The promoters promised prospective investors - mainly persons covered by public retirement systems and not by social security - that an investment sufficient to realize an annual net income of \$400 or more (the minimum amount needed to receive social security credit in a year) could eventually reap a high return through disproportionately weighted social security benefits. To address this abuse, Congress enacted section 1402(a)(13) of the Internal Revenue Code, which excludes from self-employment income an individual's "distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments ... for services actually rendered to or on behalf of the partnership ..."

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In 1997, the Treasury proposed regulations under section 1402(a)(13) defining a "limited partner" as any partner - including any member in an LLC classified as a partnership - other than a person having any of the following attributes:

- (i) has personal liability for the partnership's debts,
- (ii) has authority to contract for the partnership,
- (iii) participates in the partnership's business for more than 500 hours during the partnership's taxable year, or
- (iv) is a "service partner in a service partnership."

In partnerships in which there are limited partners meeting this definition, the proposed regulations allow a person to qualify as both a general partner and as a limited partner with respect to separate interests in the partnership, or to qualify as a limited partner despite participating in the partnership business for more than 500 hours during a taxable year. The intent of these exceptions was to "exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership." Thus, the proposed regulations explicitly acknowledge that self-employment taxes should apply only to payments for services and not to payments from capital investment and appreciation.

The 1997 proposed regulations sparked a firestorm of criticism from small business owners and others who claimed that the regulations would improperly impose self-employment tax on income that could not fairly be characterized as earnings from self-employment. The critics claimed that earnings from self-employment must be limited to the fair value of the services actually rendered for the business, and should not sweep in all income derived from the business based on arbitrary factors such as the number or hours worked or the nature of the business.¹

In response to this criticism, Congress passed legislation providing that any regulations relating to the definition of a limited partner for self-employment tax purposes not be issued or effective before July 1, 1998. To date, the 1997 proposed regulations have not been withdrawn, and no new regulations on the subject have been proposed or adopted.

TAXATION OF S CORPORATION OWNERS

Section 1402(a)(13) deals only with limited partners. However, it is instructive to consider the tax treatment of owners of S corporations, which are similar to partnerships in terms of their flow through tax treatment. It is reasonably well established that to the extent an S corporation owner renders services to or for the benefit of the corporation and is paid reasonable compensation for those services (in the form of wages or consulting fees), the owner's distributive share of the S corporation's residual income is not subject to employment taxes.

S corporation owners get into trouble when they perform material services for the corporation but do not receive reasonable compensation for their services. In those cases, the owner's entire

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distributive share of the corporation's income will generally be treated as wages subject to employment taxes.²

TAXATION OF LIMITED PARTNERSHIPS

Some entrepreneurs organize their business ventures as limited partnerships, and hold their ownership interest in the business primarily as a limited partner. A 1% (or smaller) interest is generally held through an entity (LLC or corporation) that serves as the general partner. The entrepreneur typically performs services for the business as a member or officer of the general partner entity.

If the entrepreneur receives no compensation for the services rendered for the business, the entrepreneur might take the position that the entire limited partner share of the partnership's income is exempt from self-employment tax under section 1402(a)(13). However, the IRS will likely assert that the limited partner share is, in fact, compensation for services for self-employment tax purposes. The IRS's success with similar arguments in the context of S corporations suggests that a court is likely to agree with the IRS.

Because of this risk, an entrepreneur is generally better advised to take a reasonable salary (or other compensation) from the business, and only claim exemption from self-employment tax for the residual profits allocable to the entrepreneur's limited partner interest. This approach may also be preferable in terms of generating self-employment earnings that can be used to fund a qualified retirement plan and to accrue social security credits.

TAXATION OF LIMITED LIABILITY COMPANIES

Consistent with the treatment of S corporation owners and limited partners, it is reasonably clear that if an LLC member actively manages the LLC's business and receives no separately stated compensation for those services, the IRS will treat the member's entire share of LLC income (other than statutorily exempt income) as subject to employment taxes.³

But what if the LLC member receives a separately stated salary/guaranteed payment that constitutes reasonable compensation for the services? Some argue that because LLC members are not classified as either general partners or limited partners under state law, their shares of LLC income can never escape self-employment taxes under the rule for limited partners in section 1402(a)(13). This argument seems clearly incorrect. If it were true, the very abuse that section 1402(a)(13) was designed to prevent could easily be replicated using an LLC instead of a partnership. Moreover, even the IRS conceded in the 1997 proposed regulations that LLC members may be characterized as limited partners in appropriate circumstances.

A better interpretation is that an LLC member can be both a general partner (to the extent it has authority to contract for the LLC) and a limited partner (to the extent it does not have liability for obligations of the LLC). Under section 1402(a)(13), to the extent the member receives reasonable compensation for services rendered to the LLC as a manager (general partner), the member's residual distributive share should be viewed as attributable to the member's role as a limited partner and should not be subject to self-

employment tax. This distinction between a member's role as a manager and a member's role as a member is supported by section 1402(a)(13), which expressly recognizes that a limited partner can receive compensation for services rendered to the partnership and still qualify as a limited partner with respect to a residual distributive share. Likewise, the 1997 proposed regulations recognize that an LLC member can be a limited partner, that a limited partner can also have a separate role as a general partner, and that self-employment taxes should not attach to income received in a partner's role as a limited partner.

The argument for segregating an LLC's member's distributive share of income between self-employment earnings and residual profits is even stronger for a "manager managed" LLC. In a manager managed LLC, only designated managers have the authority to contract for the LLC (as contrasted to a "member managed" LLC, in which all members have authority to contract for the LLC). The distinction between managers and members of a manager managed LLC more clearly parallels the general partner and limited partner distinction in a limited partnership, and reinforces the legitimacy of distinguishing between earnings from services as a manager and earnings from investment as a member.

In circumstances where the LLC owners who are active in the business can come within the definition of limited partner as set forth in the 1997 proposed regulations (which would generally require the presence of "pure" limited partners as defined in those regulations), it seems highly unlikely that the IRS would challenge the segregation of the active owners' income between self-employment earnings and residual profits as provided in the regulations.

PROPOSED LEGISLATION

In January 2005, the staff of the Joint Committee on Taxation prepared a report presenting a number of proposals to address tax non-compliance, including a proposal to modify the determination of amounts subject to self-employment tax for all partners and S corporation owners. The proposal would eliminate the distinctions between general and limited partners, and between partners and S corporation owners. Under the proposal:

- any partner that materially participates in the partnership business would be subject to self-employment tax on the partner's entire distributive share of partnership income (subject to possible exclusion of certain passive income as discussed below);
- any partner that does not materially participate in the partnership business would be subject to self-employment tax only on the reasonable compensation from the partnership;
- the statutory exclusions for passive type income would not be available to partners in certain service partnerships; and
- S corporations would be classified as partnerships for self-employment tax purposes.

The staff's proposal suffers from the same shortcomings as the 1997 proposed regulations: it significantly expands the tax burden on small business owners, and it relies on artificial distinctions

based on hours worked and type of business. For that reason, the proposal is likely to meet the same heavy opposition from small business owners and Congress as the 1997 proposed regulations.

Nevertheless, the report is significant in that it confirms the tax policy favoring treating LLC members, partnership partners, and S corporation shareholders consistently, and favoring the distinction between earnings from services and earnings from capital investment and appreciation. To this extent, the Joint Committee staff's report is additional support for the position that under current law an LLC member, a limited partner, and an S corporation owner should each be subject to employment taxes on their reasonable compensation from the business, and no more and no less.

CONCLUSION

It should be possible to structure a manager managed LLC such that the owners are reasonably confident that they will be subject to employment taxes on only their reasonable compensation for services performed for the LLC and not on the residual earnings of the business. This is essentially the same result as can be achieved in a limited partnership or S corporation, meaning that the limited partnership and S corporation structures offer no material self-employment tax benefits over a properly structured LLC. Therefore, self-employment taxes should not be a material reason for rejecting the LLC business entity form in favor of the generally less desirable limited partnership or S corporation form.

¹Dan R. Mastromarco, Why Small Businesses Are Upset About Sec. 1402(a) (13) & Other Trivia, 97 Tax Notes Today 86-74 (May 5, 1997).

²See, for example, Revenue Ruling 74-44 and Nu-Look Design, Inc. v. Commissioner, 356 F.3d 290 (3rd Cir. 2004).

³See Ltr. Rul. 9432018 (May 16, 1994).

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