Minimizing the Self-Employment Tax for LLC Members

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Self-Employment Tax Overview

The limited liability company (LLC) has become the entity of choice for many businesses, real estate holdings, and other joint ventures. LLCs are generally treated as partnerships for federal tax purposes unless an election is made to treat the LLC as an association taxable as a corporation for tax purposes or unless the LLC has only one member.[1] Consequently, LLCs offer favorable pass-through taxation, similar to S corporations, but with far more flexibility than S corporations provide.

One of the few negative aspects of LLCs involves the exposure of the LLC members to the self-employment tax (SE tax). This article summarizes the SE tax rules generally and discusses how the rules are applied to LLC members. It also offers several suggestions for avoiding or minimizing the SE tax for LLC members. As always, each situation needs to be evaluated based on its own facts to determine the best method for addressing this complex, and often costly, tax issue.

The SE tax is the Social Security tax equivalent imposed on persons who work for themselves. However, the self-employed person pays the equivalent of both the employer's and the employee's portion of the tax. The SE tax rate is a combined 15.3 percent that applies to the individual's first $87,000 of self-employment income (SE income) in 2003. The 2.9 percent Medicare tax portion applies to all of the individual's SE income without any limitation.[2]

Individual taxpayers in business for themselves are subject to SE tax on their trade or business income. This includes sole proprietors, independent contractors, and certain partners in partnerships, including LLC members in multiple-member LLCs taxed as partnerships. Therefore, LLC members are generally considered partners subject to SE tax. It should be noted that corporate LLC members are exempt from SE tax.

Certain types of income generally are *excluded* from the definition of SE income, including

- income or loss from the rental of real estate;
- dividends and interest income;
- gain or loss from the sale of a capital asset; and
- distributive share of income or loss allocated to a *limited partner* other than a "guaranteed payment" for services rendered by the limited partner to or on behalf of the partnership.[3]

A "guaranteed payment" is any payment made, without regard to the income of the partnership, to a partner for services provided to the partnership.[4] This would be comparable to wages paid to an employee.

It should be noted that this limited partner exception applies only to "limited partners" as defined by the SE income regulations discussed below. The definition of a limited partner under state law is not binding on the Internal Revenue Service (IRS) for this purpose. In addition, this limited partner exception does not apply to the sole member in a single-member LLC. A single-member LLC is not treated as a partnership for federal tax purposes but as an entity that is disregarded as an entity separate from its owner.[5] Therefore, the sole member of an LLC is not treated as a partner for any federal tax purposes.

Application of Self-Employment Tax to LLC Members

In proposed regulations issued on January 16, 1997, the IRS extended the statutory scheme for the SE income rules for partners (including the exception for limited partners) to individual LLC members.[6] These proposed regulations are not effective until issued as final regulations, which has not yet occurred. Unofficially, IRS representatives have stated that they are awaiting congressional guidance on this issue.

The absence of definitive guidance from the IRS concerning the application of the SE income rules to LLC members has created uncertainty for taxpayers but also a degree of flexibility. Many practitioners are applying the proposed regulations' definition of a limited partner to LLC members even though the proposed regulations are not currently binding. This is the most definitive guidance currently available, and it should be very difficult for the IRS to attack a taxpayer's use of these proposed regulations as being unreasonable. An IRS representative was quoted in June 2003 as stating that as long as taxpayers conform to the latest proposed rules, the IRS generally will not challenge what the taxpayers do with regard to SE taxes.[7] In addition, proposed regulations are considered substantial authority for purposes of avoiding the 20 percent accuracy-related penalty.[8]

[T]he self-employed person pays the equivalent of both the employer's and the employee's portion of the tax.

General Provisions of the Proposed Regulations

The proposed regulations attempt to determine whether an LLC member functions more like a general partner or a limited partner in a more traditional limited partnership. Under these rules, an individual is treated as a limited partner (and is therefore exempt from SE tax) *unless* one of the following applies to the LLC member:

- The member has personal liability for the debts or claims of the LLC solely by reason of being a member.
- The member has authority (under the law of the jurisdiction in which the entity is formed) to contract on behalf of the LLC.
- The member participates in the LLC's trade or business for more than 500 hours during the LLC's taxable year.[9]

The first limited partner disqualifier would not apply to a Michigan LLC member because the Michigan LLC Act provides that the members are not liable for the LLC's obligations.[10] This test is applied solely based on the members' position as a member. It does not include any personal liability that the LLC member assumes by guarantying an obligation of the LLC or otherwise.

All members of a Michigan LLC have the auth-ority to contract on behalf of an LLC unless the articles of organization state that the business of the LLC is to be managed by managers.[11] All members of a member-managed LLC would be treated as general partners for SE income purposes under the second disqualifier. To avoid this result, an LLC must designate in its articles of organization that it will be managed by managers and the members not designated as managers may be treated as limited partners.

The third disqualifier is applied to each LLC member on an annual basis. There is no requirement to annualize an LLC member's hours of participation and there are no attribution rules applicable when determining an individual's SE income. Therefore, services provided by an individual's spouse or other family members are not attributed to the LLC member. In addition, services provided by an individual LLC member to an entity (such as a corporation) that is also an LLC member or manager should not be considered as services provided by the individual LLC member to the LLC.

Two Absolutes

As mentioned previously, any guaranteed payments made to a member for services actually provided to an LLC constitute SE income.[12] In addition, an individual who is a "service partner in a service partnership" cannot be considered a limited partner for SE income purposes.[13] A "service partnership" is one in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[14] This definition is similar to, but not exactly the same as, a "professional service" as defined by the Michigan LLC Act for a professional limited liability company.[15]

Exceptions to the General Rule

An LLC member, except for a service partner, who is unable to qualify as a limited partner based on the general rules may be treated as a limited partner under one of two exceptions provided by the proposed regulations.

The *first exception* applies to an individual who owns more than one class of ownership interest in the LLC. To be treated as a limited partner with respect to a particular class of ownership, immediately after an individual acquires that class of ownership,

- other individuals treated as limited partners under the general rule must own a substantial, continuing interest in that class of ownership (generally 20 percent or more[16]) and
- the individual's rights and obligations with respect to that specific class must be identical to those of the other limited partners; for this purpose, guaranteed payments made for services provided to an LLC are not considered.[17]

This exception attempts to recognize that, in a limited partnership, the same individual may own both general partner and limited partner interests and that the SE income rules treat these partnership interests differently. Structuring an LLC to provide more than one class of ownership may allow an individual to be a manager and, therefore, be treated as a general partner for a smaller portion of his or her LLC interest while holding a larger portion of the LLC interest as a nonmanager member, which is classified as a limited partner interest.

The *second exception* applies to an individual who fails the limited partner definition solely because of the "500 hours of participation" test. Under this exception, an individual may be treated as a limited partner if, immediately after an individual acquires an ownership interest,

- other individuals treated as limited partners under the general rule own a substantial, continuing interest in that class of ownership and
- the individual's rights and obligations with respect to that specific class are identical to those of the other limited partners.[18]

This exception attempts to treat individuals who have made identical contributions for an identical class of ownership interest similarly for SE income purposes.

Structuring LLCs to Minimize Self-Employment Income for LLC Members

The proposed regulations create opportunities for structuring LLCs to minimize the SE income of the members. Several of these planning techniques are discussed below. Alternatively, because these regulations are not currently binding, taxpayers and their advisors are not required to structure their LLCs in compliance with the proposed SE income regulations in order to minimize the SE tax on LLC members. However, the uncertainty associated with a more flexible and aggressive approach may make it more difficult to defend the reasonableness of an alternative approach if the IRS challenges the taxpayer's application of the limited partner exception to LLC members.

Manager-Managed LLCs

LLCs that are member-managed will subject all individual members to SE tax. By stating in the LLC's articles of organization that the LLC will be managed by managers, those individual LLC members who are not designated as managers will meet the proposed regulations' limited partner definition if they participate in the LLC's trade or business for 500 or fewer hours during the LLC's tax year.

If a nonmanaging member provides more than 500 hours of service to an LLC during the year, the second exception to the general rule may be available to that member. For this exception to apply, other individual LLC members with identical rights and obligations to the active member should own at least 20 percent of the LLC and must qualify as limited partners under the general rule.

Another technique is to select a nonmember as the manager of the LLC. Nonmembers are permitted to act as managers under the Michigan LLC Act.[19] If none of the LLC members are designated as managers, only the 500-hour test could disqualify them from limited partner treatment; the exceptions to the more-than-500-hour test could provide relief to an active nonmanager member.

The nonmember manager could be a family member of an LLC member. The manager could also be an employee of the LLC who is not a member. A related entity, preferably a corporation (which is exempt from SE tax), controlled by the LLC members could be designated as the manager whether it is a member or a nonmember. The LLC members could serve as paid officers or employees of the corporation and effectively manage the LLC through the corporate manager. A fair market management fee should be paid by the LLC to the manager for the actual services provided to the LLC.

[S]ervices provided by an individual's spouse or other family members are not attributed to the LLC member.

Multiple Classes of Ownership

The proposed regulations acknowledge that an LLC member may own more than one class of ownership interest. The use of two classes of ownership to distinguish between a manager and a nonmanager class of ownership may be used to allow the larger, nonmanager membership class to be treated as a limited partner class. The smaller manager class should receive a priority preferred return of income (e.g., a management or sales fee arrangement) that is contingent on the profitability of the LLC. It may not be a fixed compensation amount or it will constitute a guaranteed payment for services, which is disregarded when determining separate classes.[20]

An LLC may be structured to admit both active, service-providing members in addition to more passive, capital-contributing members. For those LLC members who could qualify as both, it may be advisable to create two classes of ownership for these active, capital-contributing members. The portion of their LLC membership interest that is comparable to the cash-contributing members' interest should be structured as a nonmanager class qualifying for limited partner status. This class could receive a cumulative preferred-priority return of profits based on their unreturned capital contributions, whereas the smaller active manager class would not.

The proposed regulations create opportunities for structuring LLCs to minimize the SE income of the members.

Another alternative would be to structure the majority of the capital needed for the LLC's business as interest-bearing loans from the LLC members who make minimal capital contributions (however, be aware of a possible thin capitalization contention by creditors of the LLC). The payment of interest would reduce the profits of the LLC that could be treated as SE income to the LLC members. The receipt of interest income by the creditor LLC member does not constitute SE income. Written promissory notes evidencing this indebtedness are recommended. This loan alternative would also work to reduce the SE income for service partners in service partnerships.

Other Structuring Alternatives

The limited partner test is applied on an entity-by-entity basis. There are no rules requiring that related partnerships or LLCs be aggregated for SE tax purposes. By separating business activities or different locations into separate LLCs, it is less likely that individual LLC members will provide more than 500 hours of services to each separate LLC. If they are nonmanager members, they could meet the main limited partner test and their distributive share of income from the LLC would not be SE income.

Even where a nonmember is designated as a manager, if all of the members fail the 500-hour participation disqualifier, they will all be treated as general partners. In this scenario, it may be advisable for members to structure the LLC ownership to have at least 20 percent of the ownership held by nonparticipating family members of the LLC members (and in most cases, this would be a member's spouse). This would qualify the nonparticipating family members as limited partners. Under the second exception to the general rule, the nonmanager members providing more than 500 hours of service annually to the LLC could qualify as limited partners for SE income purposes.

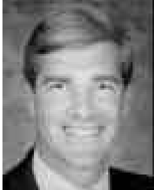
Conclusion

An individual who conducts a trade or business activity through an LLC is generally subject to SE tax on income received from the trade or business. A guaranteed payment received for services rendered by a member to an LLC constitutes SE income. The member's distributive share of the LLC's income or loss is also SE income or loss unless the LLC member is considered a limited partner as defined by the proposed regulations. However, by properly structuring an LLC, an individual member may meet the limited partner exception and minimize the SE income that could pass through from the LLC. The ability to make use of such a strategy reinforces the idea that LLCs have become the entity of choice for many business activities.

NOTES

1. Treas Reg 301.7701-3(a)–(c).
2. IRC 1401(a)–(b).
3. IRC 1402(a)(1)–(3),(13).
4. IRC 707(c).
5. Treas Reg 1.7701-3(b)(1)(ii).
6. Prop Treas Reg 1.1402(a)-2(g)–(h).
7. Alison Bennett, *Taxpayers Can Rely on Proposed Regulations Or LLC Self-Employment Taxes, Clark Says,"* Daily Tax Report, June 13, 2003, at G-3.
8. Treas Reg 1.6662-4(d)(3)(iii).
9. Prop Treas Reg 1.1402(a)-2(h)(2).
10. MCL 450.4501(2).

11. MCL 450.4401.
12. Prop Treas Reg 1.1402(a)-2(g).
13. Prop Treas Reg 1.1402(a)-2(h)(5).
14. Prop Treas Reg 1.1402(a)-2(h)(6)(iii).
15. MCL 450.4902(b).
16. Prop Treas Reg 1.1402(a)-2(h)(6)(iv).
17. Prop Treas Reg 1.1402(a)-2(h)(3).
18. Prop Treas Reg 1.1402(a)-2(h)(4).
19. MCL 405.4402(2).
20. Prop Treas Reg 1.1402(a)-2(h)(6)(i).



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