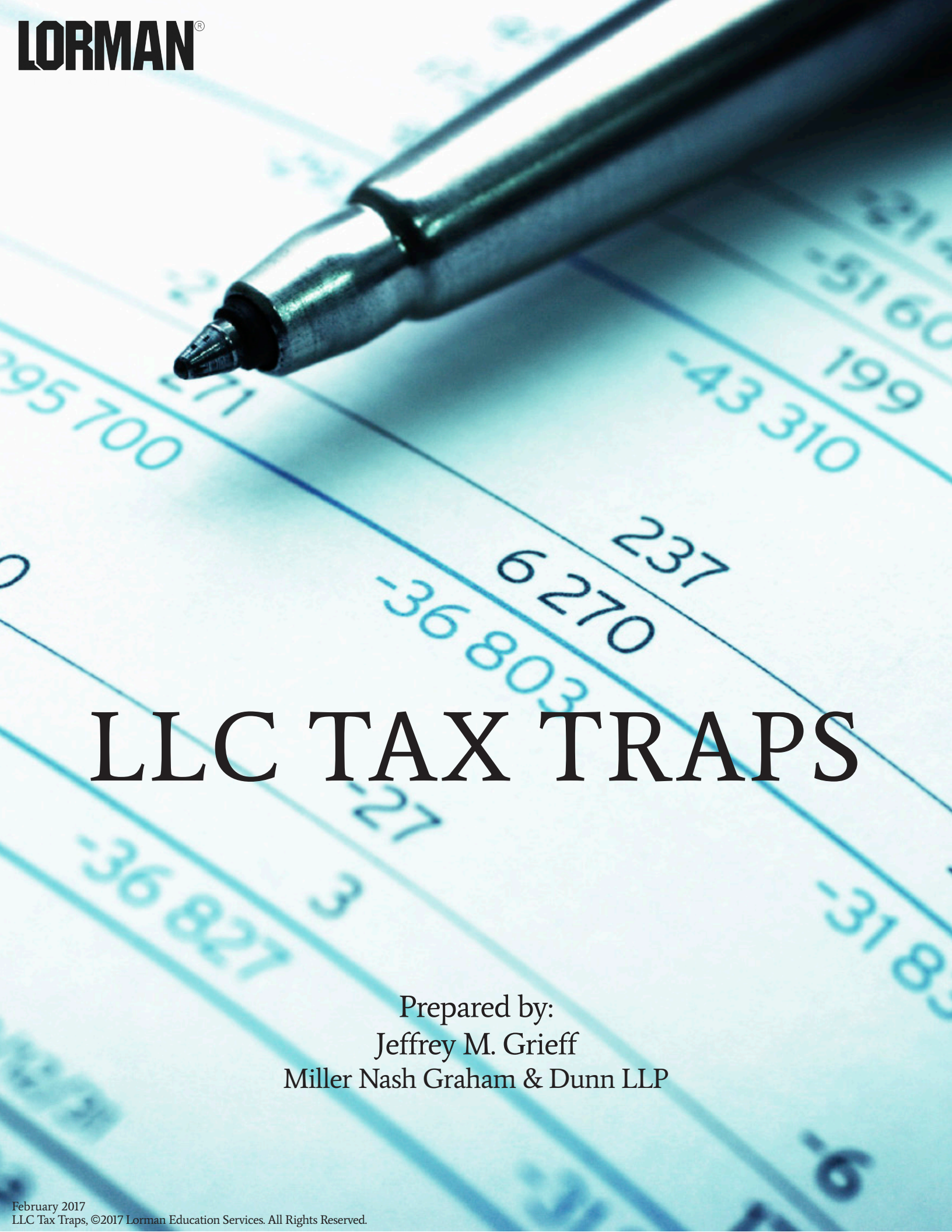

LLC TAX TRAPS

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LLC TAX TRAPS

A. WILL AN LLC ALWAYS BE TAXED AS A PARTNERSHIP?

The goal of certainty of result for the tax status of an LLC is an important obligation of the Company's lawyer and CPA, and an inherent trap to the uninformed. The tax status of an LLC can inadvertently become taxed as a Subchapter C Corporation rather than as a partnership if the formation documents are not correctly drafted. This is opposed to the Form 8832 Entity Election and Form 2553 Subchapter S Election or the remedial discretion of the IRS set forth in Revenue Procedure 2013-30.

The specific characteristics of the LLC determine its classification as a partnership or as an association taxable as a corporation and avoid being subject to corporate income taxes.

These are **four (4) of the key features** that distinguish a corporation for federal tax purposes:

1. Continuity of life.
2. Centralized management.
3. Free transferability of interests.
4. Liability for corporate debts limited to corporate property.

To qualify for partnership tax status, an LLC generally can have no more than two of these four corporate characteristics.

Generally, when an LLC is taxed as a partnership, each member's share of income from the LLC generally is taxable as earnings from self-employment. However, some LLC members may be able to limit their self-employment income to guaranteed payments received for services to the LLC as detailed in Section C. The point is that LLC members, as partners in a partnership, will receive a Form K-1 Information Return to report their respective share of income, loss, deductions and credits at graduated individual tax rates on their 1040 tax returns. This is similar to income taxation of a sole proprietorship, but opposed to income taxation under a Subchapter C and Subchapter S Corporation.

B. TAX TRAPS FOR INVESTOR MEMBER (LIMITED PARTNER) VS. OPERATING MEMBER (MANAGER OR SERVICE MEMBER)

If the LLC is treated as a partnership, the members may be subject to self-employment tax on their earnings from the partnership (IRC §1402(a), Regulation §1.1402(a)) and Proposed IRS tax regulations §1.1402(a)-2 which generally treats members of an LLC like limited partners in a limited partnership, so that certain members of an LLC would not be subject to self-employment tax on their distributive share of earnings from the LLC.

The Safe harbor rule "investor status member" designation vs. "member" is under the 1997 proposed regulations, a member of an LLC is taxed as a limited partner unless: (1) the member is personally liable for the obligations of the LLC; (2) the member has agency authority to contract on behalf of the LLC; (3) the member participates in the trade or business of the LLC for more than 500 hours during a year; or (4) the member is a service provider and the LLC is a service-related organization.

LLCs generally are subject to the various federal income tax statutes that govern partnerships. The statutes are enumerated in Internal Revenue Code Section 1402 and the accompanying income tax regulations.

Section 1402(a) generally defines net earnings from self-employment (NESE) for purposes of determining a tax base to which self-employment taxes will be applied. Specifically, net earnings for self-employment include compensation and a member's distributive share of income or loss from any business carried on by a partnership.

However, Section 1402(a)(13) provides a controversial exception, stating that the distributive shares of income or loss of limited partners, other than guaranteed payments, will be excluded from net earnings from self-employment income. Accordingly, limited partners/members of an LLC are exempt from paying self-employment taxes on their distributive share of income or loss.

The issue and tax trap — and the controversy among taxpayers over who is liable for self-employment taxes — stems from how the statute defines a limited partner for purposes of determining net earnings from self-employment.

- **Limited Partner Defined**

The definition of a limited partner has narrowed in recent years, ultimately making it more difficult for LLC members to qualify for the limited partner exception of Section 1402(a)(13). For example, the Section 1.1402 regulations that were proposed in 1994 — but never were finalized — made a distinction between individuals owning an interest in limited partnerships and those owning interests in LLCs. Specifically, under the 1994 regulations, a taxpayer owning an interest in an LLC was treated as a limited partner if the individual did not make management decisions concerning the LLC's business; the LLC could have been formed as a limited partnership in the same jurisdiction; and the member could have qualified as a limited partner in the limited partnership.

The 1994 regulations were revised (withdrawn and replaced) by regulations proposed in 1997. While the 1994 regulations distinguished between taxpayers owning an interest in limited partnerships and taxpayers owning interest in LLCs, the 1997 regulations apply to any entity classified as a partnership for federal income tax purposes, regardless of its classification under applicable state statute. Accordingly, the same standards apply in determining the self-employment tax status of taxpayers that own interest in limited partnerships and in LLCs. Specifically, 1997 proposed Section 1.1402-2(h)(2) allows a member of an entity that is classified as a partnership for federal income tax purposes to be treated as a limited partner that is not subject to self-employment tax.

IF THE TAXPAYER IS A SERVICE PARTNER IN A SERVICE PARTNERSHIP OR MEETS ANY ONE OF THE FOLLOWING TESTS, (A) HAS PERSONAL LIABILITY FOR THE DEBTS OF OR CLAIMS AGAINST THE ENTITY BY REASON OF BEING A MEMBER; (B) HAS THE AUTHORITY TO CONTRACT ON BEHALF OF THE ENTITY; OR (C) PARTICIPATES IN THE ENTITY'S TRADE OR BUSINESS FOR MORE THAN 500 HOURS DURING THE ENTITY'S TAXABLE YEAR, THE TAXPAYER WILL REPORT THEIR PROPORTIONATE SHARE OF INCOME FROM THE PARTNERSHIP AS NET EARNINGS SUBJECT TO EMPLOYMENT TAXES.

- **Federal Self-Employment Tax Implications**

The 1997 regulations provide some authority that an LLC member under appropriate circumstances qualifies as a limited partner, thus precluding the member's proportionate share of LLC income from self-employment tax pursuant

to Section 1402(a)(13). However, LLC members should be cautious in taking a federal income tax return position that is contrary to the narrow construction of the 1997 regulations.

- **Exceptions:**

Exception to the General Rule of section 1.1402(a)-2(h)(2) of the 1997 Proposed Regulations (the General Rule):

i. Exception for partners who hold two classes of interest. Under sections 1.1402(a)-2(h)(3) of the 1997 Proposed Regulations (the Multiple Class of Interest Exception), an individual who holds more than one class of partnership interest in a partnership and who does not meet the definition of a limited partner under the General Rule can still be treated as a limited partner if (i) partners who meet the General Rule definition of a limited partner own a substantial continuing interest in that class, and (ii) the rights and obligations of all holders of that class of partnership interest are identical. For that purpose, section 1.1402(a)-2(h)(6)(iv) provides that a substantial interest in a class of interest is determined based on all of the relevant facts and circumstances, but that in all cases, however, ownership of 20% or more of a specific class of interest is considered substantial.

ii. Exception for partners who materially participate and hold a single class of partnership interest. Under section 1.1402(a)-2(h)(4) of the 1997 Proposed Regulations (the Single Class of Interest Exception), an individual who does not meet the definition of a limited partner under the General Rule solely because that individual fails the 500-Hour Test can still be treated as a limited partner if (i) partners who meet the General Rule definition of a limited partner own a substantial continuing interest in the same class of partnership interest as that owned by the individual and (ii) the rights and obligations of all holders of that class of partnership are identical. The Single Class of Interest Exception does not apply to individuals who are treated as general partners by reason of the Liability Test or the Authority Test.

iii. Treatment of service partners in a service partnership. Under section 1.402(a)-2(h)(5) of the 1997 Proposed Regulations, an individual who is a service partner in a service partnership cannot qualify as a limited partner under the General Rule or either the Multiple Class of Interest Exception or Single Class of Interest Exception. A service partner is a partner who provides services to or on behalf of a service partnership's trade or business. An individual is not considered to be a service partner if they provide only a de minimis amount of services to or

on behalf of a service partnership. A service partnership is a partnership in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (a 1997 Proposed Regulations Service Partnership).

- **Frank M. Sands, Jr. Case**

In general, section 1402(a)(13) excludes from self-employment taxes the distributive share of income or loss of a limited partner – other than for certain guaranteed payments for services rendered to the partnership by the partner. To qualify according to the literal terms of this exclusion, many participants in the in the investments fund industry have formed their management entity as a limited partnership in a jurisdiction that permits active participation in the entity's business by limited partners without forsaking limited liability. These individuals take the position that income allocated to them in their capacity as limited partners qualifies for the exclusion and is not subject to self-employment tax.

Recent cases and IRS administrative guidance have created some concern with this structure. Specifically, the Tax Court in Renkemeyer v. Commissioner [1] and a U.S. district court in Riether v. United States [2] determined that state law limited liability partners and limited liability company members did not qualify for the limited partner exception. Portions of these opinions highlighted the active participation of the partners/members and how this participation was inconsistent with the purposes of the limited partner exception. Subsequently, in Chief Counsel Advice 201436049 [3], the IRS specifically challenged a structure in which the investment fund management entity was formed as a limited liability company and the members took the position that they were exempt from self-employment tax as limited partners.

[1] 136 T.C. 137 (2011)

[2] 919 F. Supp. 2d 1140 (D. N.M. 2012)

[3] Chief Counsel Advice 201436049 (May 20, 2014)

While the IRS's answer, filed on May 8, 2015, in Sands may imply that the IRS will be hesitant to assess self-employment tax against participants in a management entity who are allocated income as a limited partner under current law, there are signals that the law may soon change.

"The current Treasury Priority Guidance Plan lists as one of the anticipated guidance items: "guidance on the application of section 1402(a)(13) to limited liability companies." [4] Informal statements made by at least one individual participating in this guidance imply that the guidance may not be limited to the treatment of LLC members as limited partners, as the description seems to indicate.[5] These statements leave open the possibility that the guidance could treat certain state law limited partners as other than limited partners for purposes of section 1402(a)(13).[6]"

[4] (*IRS, Treasury Release 2014-2015 Priority Guidance Plan,* 2014 Tax Notes Today 166-15 (Aug. 27, 2014) (Executive Compensation, Healthcare, and Other Benefits, and Employment Taxes – Item 16)

[5] Amy Elliot, *Scope of Self-Employment Tax Exemption Guidance Could Be Broad*, 2014 Tax Notes Today 232-1 "(quoting Craig Gerson, an attorney-advisor in Treasury's Office of Tax Legislative Counsel, as stating, "We're hoping to issue guidance on section 1402(a)(13) that will apply to LLCs, because that's the area where guidance is most warranted. That doesn't restrict our ability to apply it more broadly as appropriate. We want to consider the whole landscape.")."

[6] Such guidance would be consistent with the recommendation made by the Tax Section of the New York State Bar Association. *See NYSBA Submits Report on Application of Employment Taxes to Partners*, 2011 Tax Notes Today 220-21 (Nov. 15, 2011.)

C. DISREGARDED ENTITY CLASSIFICATION

You have the option to select the tax-wise choice that best fits the member's objectives. In doing so, you can avoid the pitfalls by being informed as to selections in Form 8832, awareness of the "disregarded entity" classification in single member LLCs (SMLLC) and most importantly, if you select to be taxed as an association, filing Form 2553 to elect Subchapter S status for the association (corporation).

In 1997, the IRS issued new regulations that generally allowed any LLC to choose whether it was to be taxed as a partnership or a corporation by "checking the box" as to what kind of taxable entity it wanted to be and allowing one-owner LLCs to be ignored as entities for tax purposes -- a "disregarded entity" -- equivalent to a sole proprietorship.

“Unless an election is made on IRS Form 8832, a domestic eligible entity is:

1. A partnership if it has two or more members.

2. Disregarded as an entity separate from its owner if it has a single owner.

A change in the number of members of an eligible entity classified as an association does not affect the entity’s classification. However, an eligible entity classified as a partnership will become a membership is reduced to one member and is disregarded entity will be classified as a partnership when the entity has more than one member.

“A disregarded entity is an eligible entity that is treated as an entity that is not separate from its single owner. Its separate existence will be ignored for Federal tax purposes unless it elects corporate tax treatment.”

The Federal tax treatment of elective changes in classification as described in Regulations section 301.7701-3(g)(1) is summarized in the instructions to Form 8832 as follows:

- If an eligible entity classified as a partnership elects to be classified as an association, it is deemed that the partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

- If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, it is deemed

that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.

- If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.

For example, a single member limited liability company (SMLLC) formed under state laws as a LLC can elect on Form 8832 under 2(a) to be treated for tax purposes as a corporation and further elect on Form 2553 "Election by a Small Business Corporation" to be classified as a Subchapter S corporation. Why?

Two or more owner LLCs are treated by default as a partnership -- a "pass through entity" -- unless the members elect corporate tax treatment by filing and checking the box on IRS Form 8832.

The profits and losses of a Disregarded Entity is reported on the sole member's individual Income Tax Return 1040 on Schedule C.

D. SELF-EMPLOYMENT TAXATION FROM INCOME TO MEMBERS

The federal individual income taxation of members is always an important avenue to explore with the organizers of the LLC.

Because an LLC is taxed as a partnership, the members are taxed as partners. Generally, a member's LLC wages and proportionate share of LLC earnings are classified as self-employment income subject to employment taxes.

The facts and objectives of the LLC and its members will determine whether a member is subject to earned income subject to employment taxes. If you are not well armed by understanding this Section, you could fall into an unfortunate trap and not make the proper tax-wise decision.

Partners in a partnership (including members of a limited liability company (LLC)) are considered to be self-employed, not employees, when performing services for the partnership. LLC Members cannot be classified as employees of the LLC. Revenue Ruling 69-184 states that "members of a partnership are not employees of the partnership." Members of the LLC can receive compensation in

the form of self-employed income for rendering services. This is a common tax trap. Always review the tax reporting of an LLC to make this determination and take corrective action if necessary.

- **General Partner.** If you are a general partner of a partnership (or treated as a general partner in an LLC) that carries on a trade or business, your net earnings from self-employment include your distributive share of the income or loss from that trade or business. General partners must also include guaranteed payments for services rendered to, or on behalf of, the partnership **AS NET EARNINGS FROM SELF-EMPLOYMENT**.

- **Limited Partner.** If you are a limited partner of a partnership (or treated as a limited partner in an LLC) that carries on a trade or business, only guaranteed payments for services you rendered to, or on behalf of, the partnership are **NET EARNINGS FROM SELF-EMPLOYMENT**. Limited partners do not pay self-employment tax on their distributive share of partnership income, but do pay self-employment tax on guaranteed payments.

- **LLC Income:**

There are 3 ways a member can receive income from an LLC.

A member's share of the income of an LLC may be classified in 1 of 3 ways: (1) LLC wages are subject to NESE and self-employment taxation, (2) guaranteed payments are self-employment (NESE) and are subject to self-employment taxation, or (3) distributive share of partnership income or loss that is neither wages nor NESE.

The classification is significant in determining not only whether a member's share of LLC income is subject to self-employment tax, but also whether the income may serve as a basis for contributions to a qualified plan for tax purposes. (Section 401(c)(1)(B))**.**

Because of the pass-through nature of partnerships, members are generally considered to be doing the business of the partnership. The member's distributive share of income or loss from the business of the partnership is classified as a partner distributive share of income or loss. This is known as the member's "distributive share" under IRC Section 702. IRC Section 1402(a)(13) provides that the distributive share of partnership income of a limited partner - - other than guaranteed payments - - is not included in self-employment income. LLC

members are a hybrid of general partnership and limited partnership interests. (**See Section 1B)** A member of an LLC can be compensated by classifying the compensation as a "guaranteed payment." This amount is governed by IRC Section 707 and is subject to self-employment tax.

- **Tax Traps for an LLC can occur in the initial selection of the management structure of the LLC.**

i. Member-managed LLC. Under most state LLC laws, all members of a member-managed LLC have apparent authority to contract for the LLC. Therefore, even though members of the LLC do not have personal liability for LLC debts and obligations, no member of a member-managed LLC can meet the General Rule definition of a limited partner for Self-Employment Tax purposes under the 1997 Proposed Regulations. Furthermore, as there are no members in a member-managed LLC who can meet the General Rule definition, there also cannot be any LLC members who meet either the Multiple Class of Interest Exception or the Single Class of Interest Exception because each of those exceptions depends on their being members meeting the General Rule definition of a limited partner who hold a continuing and substantial interest in a specific class of membership interest. **THEREFORE, UNDER THE 1997 PROPOSED REGULATIONS MEMBERS OF A MEMBER-MANAGED LLC WILL CONTINUE TO HAVE THEIR ENTIRE DISTRIBUTIVE SHARE OF LLC BUSINESS INCOME TREATED AS NESE.**

ii. Manager-managed LLC

a. Non-manager member. Under most state LLC laws, the managers of a manager-managed LLC have exclusive authority to manage the LLC and members who are not managers do not have apparent authority to contract for the LLC. **THUS, UNDER THE GENERAL RULE, A NON-MANAGER MEMBER IN A MANAGER-MANAGED LLC WHO DOES NOT FAIL THE 500-HOUR TEST WILL BE TREATED AS A LIMITED PARTNER FOR SELF-EMPLOYMENT TAX PURPOSES.** Even if the non-manager member fails the 500-Hour Test (provided he/she/it does not qualify as a service partner in a 1997 Proposed Regulations Service Partnership), the member may be treated as a limited partner for Self-Employment Tax purposes under either the **MULTIPLE CLASS OF INTEREST EXCEPTION OR THE SINGLE CLASS OF INTEREST EXCEPTION.** Both of these exceptions require that non-manager members who do not provide more than 500 hours if service for the LLC own a continuing and substantial interest in the class of membership interest

held by the non-manager member seeking the benefit of the exceptions. Thus, a manager-managed LLC with a single non-manager member who fails the 500-Hour Test could not meet either of those exceptions.

b. Manager member. Manager members in a manager-managed LLC have apparent authority to contract on behalf of the LLC. Therefore, even though manager members do not have personal liability for LLC debts and obligations, **A MANAGER MEMBER CANNOT QUALIFY AS A LIMITED PARTNER FOR SELF-EMPLOYMENT TAX PURPOSES UNDER THE GENERAL RULE**. However, if the individual who hold a membership interest as a manager member also holds a second economic class of membership interest, the **MULTIPLE CLASS OF INTEREST EXCEPTION** may apply to make the distributive share of LLC Business Income attributable to the second class of membership interest to not be treated as NESE. That requires that there be non-manager members in the LLC who hold the same class of membership interest and who meet all the requirements of the General Rule, including the requirement that they do not fail the 500-Hour Test. Those other non-manager members must hold a substantial and continuing interest in that class of membership interest. Note that a manager member in a manager-managed LLC cannot meet the Single Class of Interest Exception because the manager-member does not fail to meet the General Rule solely because he provides more than 500 hours of service. **THE POSSESSION OF APPARENT AUTHORITY TO BIND THE LLC TAKES THE MANAGER MEMBER OUT OF THE SINGLE CLASS OF INTEREST EXCEPTION.**

E. ENTITY CLASSIFICATION ELECTION FORM 8832

Form 8832 is a "check the box" form and requires a certain level of understanding to (1) decide to make an election, and (2) which election to make or "check the box."

The Form 8832 instructions provide:

- **Single Member LCC (SMLLC) on Form 8832**

A disregarded entity is an eligible entity that is treated as an entity that is not separate from its single owner. Its separate existence will be ignored for federal tax purposes unless it elects corporate tax treatment.

- **Possible Elections:**

The federal tax treatment of elective changes in classification as described in Treas. Reg. § 301.7701-3(g)(1) is summarized in the instructions to Form 8832 as follows:

- If an eligible entity classified as a partnership elects to be classified as an association (a corporation for tax purposes), it is deemed that the partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.
- If an eligible entity classified as an association elects to be classified as a partnership, it is deemed that the association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, it is deemed that the association distributes all of its assets and liabilities to its single owner in liquidation of the association.
- If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association.

EXAMPLE 1: An SMLLC can elect on Form 8832 to be treated for tax purposes as a corporation and further elect on Form 2553, "Election by a Small Business Corporation," to be classified as a Subchapter S corporation. Why?

Two or more owner LLCs are treated by default as a partnership – a "pass through entity" – unless the members elect corporate tax treatment by filing and checking the box on IRS Form 8832 to avail themselves of the income and employment tax benefits of a Sub-Chapter S Election.

The partnership to be classified as a corporation will be deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners.

EXAMPLE 2: If an eligible entity classified as a corporation elects to be classified as a partnership, it is deemed that the corporation distributes all of its assets and liabilities to its shareholders in liquidation of the corporation, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership (LLC).

EXAMPLE 3: If an eligible entity classified as a corporation elects to be disregarded as an entity separate from its owner, it is deemed that the corporation distributes all of its assets and liabilities to its single owner in liquidation of the corporation.

EXAMPLE 4: If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as a corporation, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the corporation in exchange for the stock of the corporation.

Revenue Procedure 2013-30 provides for integrated remedial procedures to cure a late filing, at the discretion of the Department of Treasury.