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IRS still gives little guidance on self-employment tax for LLC members

TAXING MATTERS
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Does a member of an LLC pay self-employment tax on his or her income? Though LLCs have existed for decades, there is still no clear answer to this question, and the IRS has been reluctant to offer guidance.

A new ruling offers a hint as to the IRS's current thinking, confirming that where LLC members provide services to the LLC, self-employment tax is due.

Self-employment tax applies to all income that an individual earns from carrying on a trade or business. For example, an independent consultant or a professional video game player would pay tax on all of their earnings from their work.

The tax is significant. There are two components: Social Security tax and Medicare tax. Social Security tax is imposed at a rate of 12.4 percent but caps out at $118,500 in income. The real hit for large earners comes from the Medicare tax, which though imposed at the relatively modest rate of 3.8 percent (including the additional Medicare tax under Obamacare), applies to an unlimited amount of income.

Self-employment tax applies not only to income from a business that an individual carries out directly, but also can apply to an individual's partnership income.

When an individual is a partner in a partnership, his share of partnership income flows through the partnership and is taxed on his personal tax return. Originally, all partnership income was subject to self-employment tax, but in the 1970s Congress changed the law to exclude earnings of "limited partners" from self-employment tax.

Typically, there are two kinds of partners under partnership law: general partners and limited partners. General partners participate in the management of the partnership but do not enjoy limited liability protection. Limited partners have limited liability protection but don't participate in management.

Congress stated that it wanted to exclude limited partners' earnings from self-employment tax because they are "basically of an investment nature"—not earnings from providing services.

This was all well and good. With the advent of LLCs, however, which are taxed as partnerships but provide limited liability protection to all members, the situation became confused.

Under the Uniform Limited Partnership Act as it existed prior to LLCs, a partner would never have both limited liability and the ability to participate in the business; participating in the business would cause a limited partner to lose his limited liability protection.

However, all LLC members enjoy limited liability and also can participate in management. Can an LLC member be a "limited partner" who does not pay self-employment tax on his distributive share if his interest is in the nature of an investment?

Though this is common, there is very little guidance.

In 1997, the IRS issued proposed regulations that said that an LLC member's partnership income would not be subject to self-employment tax unless the member had:

1. personal liability for LLC's debts;
2. authority to contract for the LLC; or
3. participated in the LLC's business for more than 500 hours per year.

The proposed regulations ignited a political firestorm, and Congress actually imposed a moratorium on the IRS's finalizing them. While that moratorium has expired, the proposed regulations have never been finalized, and practitioners tend not to rely on them.

The issue has been litigated several times over the years. In one case, the tax court ruled that the partners in a law firm, organized as an LLP (similar to an LLC but for professional services firms) were all subject to self-employment tax on their earnings because they are all actively performing services, rather than making investments. Still, the issue remains open and is a continual source of confusion.

The recent IRS ruling, CCM 20143609, is not earth-shattering, but it has received a great deal of attention given the extraordinarily sparse authority in this area. It concerns an audit by the IRS of a management company for a family of investment partnerships. The company carried on investment activities for the partnership in exchange for a fee. All the management company members worked full time for the management company performing professional services.

On audit the IRS discovered that the management company had treated all of its members as limited partners who were not subject to self-employment tax. It separately paid them an allocated wage amount, which it subjected to self-employment tax (a no-no, as the IRS has held that partners cannot be employees), but did not apply self-employment tax to the members' distributive share.

Based on the legislative history and limited case law, the IRS found that the members' earnings were subject to self-employment tax: They were not in the nature of a return on a capital investment (even though some of the members paid a great deal for their interests) and were, instead, a direct result of the services they rendered on behalf of the management company. In other words, they were not "limited partnership" interests, despite the limited liability protections of the LLC.

One of the most interesting aspects of the ruling is the argument that the taxpayer used in its defense: the contrast with the rules for S corporations. Self-employment tax applies differently to S corporations than to partnerships. S corporations are required to pay their shareholders reasonable compensation for services rendered, which is subject to self-employment tax, but all other earnings of the S corporation

are not subject to self-employment tax. The management company in the ruling happened to have been an S corporation in the past. Its counsel argued that because the management company has the same role and business as the S corporation it succeeded, it should be able to continue to apply the same reasonable compensation rules. The IRS really had nothing to say in response to this argument—other than to point out that the rules for partnerships are different from those for S corporations. This of course makes no sense, but it is very clearly the law.

The ruling is a useful reminder that LLC members who provide services are subject to self-employment tax and the IRS—despite the astounding lack of guidance in this area—will audit this issue. Guidance on this topic remains on the IRS's priority list, but if history is any guide, we may be waiting for a long time.

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