

# JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 18 (April 18, 2005)

## THE SELF-EMPLOYMENT TAX LIABILITY OF LLC MEMBERS – THE BASICS

For 2005, the Self-employment Tax (the “SET”) applies at a rate of 15.3 percent on the first \$90,000 of income from services and 2.9 percent of any excess. The persons who are liable for the tax are (i) as the name of the tax indicates, self-employed individuals; and (ii) individuals who are members of “multi-owner unincorporated business entities” – e.g., most general partnerships, limited partnerships and LLCs – that are taxable as partnerships under Internal Revenue Code Subchapter K.

What are the rules governing the SET liability of individuals who are LLC members? Since there are tens of thousands of such individuals in NH and millions of them nationwide, the question is an important one – and all the more so since the rate of the tax is high and since so many individuals who are LLC members hate paying it.

The Internal Revenue Code section that determines liability for the SET is Section 1402. Section 1402(a)(1) provides, in general, that self-employed individuals and “partners” owe the tax. However, various subsections of the section exclude from the tax interest, dividends, and capital gains, and Section 1402(a)(13) provides that “limited partners” don’t owe the tax on their “distributive shares of partnership income.”

Thus, for LLC members whose LLCs earn income other than interest, dividends and capital gains, the key SET question is: Which LLC members are “limited partners” under Section 1402(a)(13) and which are not?

The answer to this question is provided by Prop. Reg. §1.1402(a)-2 (the “Prop. Reg.”), a proposed regulation that the IRS issued all the way back on January 13, 1997 but has never withdrawn or amended. For reasons I’ll explain in a subsequent newsletter, even though the Prop. Reg. is technically only a *proposed* regulation, you should think of it as being, for most purposes, fully binding on both taxpayers and the IRS.

The rules of the Prop. Reg. can be summarized as follows:

- 1) All individuals who are members of member-managed LLCs are deemed to be “general partners” for purposes of Section 1402; these individuals owe SET on their entire share of LLC income. All individuals who are members of LLCs whose certificates of formation or similar constitutive documents (called in many states “articles of organization”) or whose operating agreement indicates that these LLCs are “member-managed” are deemed to be general partners under Section 1402 and must pay SET on their entire share of LLC income. This will be so even if these individuals are completely passive investors in their LLC.

An LLC is “member-managed” if its certificate of formation or operating agreement indicates that each member has the right to sign contracts on behalf of the LLC. (The mere fact that a particular member has no interest in signing an LLC contract and, indeed, would never think of doing so is irrelevant to the issue of whether the member has contract-signing authority.)

An LLC formed under the New Hampshire LLC Act is member-managed if its certificate of formation provides that its management “is not vested in a manager or managers.”

- 2) The four tests for limited partner status. Individuals who are members of a manager-managed LLC – i.e., an LLC whose certificate of formation and operating agreement provide that the LLC’s management is centralized in one or more persons specifically appointed as managers – will be deemed to be limited partners under Section 1402(a)(13) and thus will not owe SET on their shares of LLC income if they meet each of the following four tests:
  - a) They must lack personal liability for debts of their LLC.
  - b) They must lack contract-signing authority for their LLC.
  - c) They must not work more than 500 hours for their LLC in the relevant LLC taxable year.
  - d) They must not be members of “service” LLCs. Service LLCs are those whose primary activities are in the fields of accounting, actuarial science, architecture, consulting, engineering, health and law.
- 3) The “single-class-of-interest rule” for avoiding SET. Under the Prop. Reg. “single-class-of-interest rule,” individuals who own interests in a single class of LLC interests and who pass all of the above four tests except for the 500-hour test can avoid SET on their income in respect of that class if a “substantial portion” of the interests in the class is owned by other members who pass all four tests. Under a safe harbor provided in the Prop. Reg., the IRS will deem a substantial portion of the above interests to be owned by persons who pass all four tests if these persons own at least 20% of all interests in it.
- 4) The “two-classes-of-interests rule” for avoiding SET. Individuals who own interests in two or more classes of LLC interests and who flunk one or more of the above four tests will nevertheless be able to avoid SET on their income in respect of any LLC class of interest of which they own an interest if a substantial portion of the interests in that class are owned by persons who pass all four tests.

A few of the rules of the Prop. Reg. for determining the SET liability of LLC members are reasonably clear even on a first reading. However, many Prop. Reg. rules – e.g., the single-class-of-interest rule and the two-classes-of-interests rule - can’t be fully understood except on the basis of detailed explanations and examples. I’ll provide you with these explanations and examples in subsequent issues of this newsletter. And in the issue of the newsletter that will be published in May 2005, I’ll explain why I’ve stated above that even though the Prop. Reg. is merely proposed, you should treat it for most purposes as if it were final.