

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

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IN ADVISING LLC MEMBERS ON HOW TO AVOID THE SELF- EMPLOYMENT TAX, CAN YOU RELY ON A MERE *PROPOSED* REGULATION?

EXECUTIVE SUMMARY. Prop. Reg. §1.1402(a)-2 (the "Prop. Reg.") provides IRS guidance to members of LLCs that are taxable as partnerships as to the Self-employment Tax ("SET") liability of these members. This newsletter expresses the view that the Prop. Reg. will very probably be followed by the IRS in any SET audit; that the Prop. Reg. will very probably bind the IRS in litigation; but that it probably will *not* bind LLC members themselves in litigation with the IRS regarding certain unreasonable rules that it contains.

DISCUSSION. For thousands of individuals who are members of New Hampshire multi-member LLCs taxable as partnerships and for hundreds of thousands of LLC members in other states, the question of how to reduce or eliminate their Self-employment Tax ("SET") on their shares of LLC income is of major importance. However, as indicated in last month's issue of this newsletter, the only IRS guidelines on the question are set forth in a regulation that is merely *proposed* – namely, Prop. Reg. §1.1402(a)-2. The IRS issued the Prop. Reg. on January 13, 1997 and has never withdrawn or modified it.

In advising clients who are LLC members about SET issues, every legal and tax professional must face a difficult threshold issue – namely, the issue whether you can rely on the Prop. Reg.

There are numerous cases that state or strongly suggest that you cannot. See, *e.g.*, *LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984), which holds that "proposed Regulations are [merely] suggestions made [by the IRS] for comment"

As a result of cases like *LeCroy*, many tax professionals feel that in advising LLC members about their SET liability, they are on their own, with only their wits to guide them. And I can attest from personal experience that the advice given to LLC members by some of these professionals on SET matters is, to state the matter tactfully, creative, and departs significantly from the rules contained in the Prop. Reg.

I believe that tax professionals who take the view that the Prop. Reg. is unreliable and that in advising clients they may disregard it are dangerously wrong. Set forth below are (i) three important propositions about the Prop. Reg. of which I believe any tax professional can be reasonably certain; and (ii) briefly, the grounds for these propositions.

Proposition 1 UNDER *ELKINS V. COMMISSIONER*, 81 T.C. 669 (1983) (THE “ELKINS CASE”) AND RELATED AUTHORITIES, THE PROP. REG. IS BINDING ON THE IRS WITH REGARD TO LLC MEMBERS WHO REASONABLY RELY ON IT.

Under the *Elkins* case, the various cases that have followed it, and T.A.M. 9410004 (March 11, 1994), in which the IRS itself has implicitly acknowledged its validity, the IRS is bound even by *proposed* regulations in tax controversies with taxpayers who reasonably rely on these regulations. Furthermore, given the substantial time, effort and expertise applied by the IRS in developing the Prop. Reg., any LLC member who relies on it must be deemed to be doing so “reasonably.”

Proposition 2 IN ANY AUDIT OF THE SET LIABILITY OF AN LLC MEMBER, THE IRS WILL APPLY THE PROP. REG. AND WILL NOT APPLY ANY ALTERNATIVE GUIDELINES.

- On June 13, 2003, Lucy Clark, a national issue specialist in the IRS’s Examination Specialization Program, publicly stated as follows: “If [a] taxpayer conforms to the [Prop. Reg.], we generally will not challenge what they do or don’t do with regard to Self-employment Taxes.” Alison Bennett, “Taxpayers Can Rely on Proposed Regulations for LLC Self-employment Tax, Clark Says,” 114 BNA’s Daily Tax Report (Friday, June 13, 2003) Page G-3.

Obviously, Ms. Clark’s statement is not binding on the IRS. However, it provides tax advisers with a strong basis for believing that in any audit of an LLC member’s SET liability, the IRS will look to the Prop. Reg. as the sole source of its audit guidelines.

- Moreover, as indicated above, before issuing the Prop. Reg. the IRS devoted a great deal of time and effort to the issues that it addresses. We can be confident that, having done so, the IRS will not lightly set the regulation aside in any SET audit.
- Finally, even if, in auditing the SET liability of an LLC member, the IRS were tempted to depart from the Prop. Reg., a forceful reference to the *Elkins* line of authorities by the member’s tax professional would very probably bring the IRS to its senses.

Proposition 3 ALTHOUGH THE PROP. REG. IS BINDING ON THE IRS, IT ARGUABLY IS *NOT* BINDING ON LLC MEMBERS WITH RESPECT TO ANY PROP. REG. RULE THESE MEMBERS CAN SHOW TO BE UNREASONABLE.

In my view, most of the rules contained in the Prop. Reg. are reasonable but a few clearly are not. For example, I believe that the Prop. Reg. rule that members of professional LLCs (i.e., LLCs active in the fields of accountancy, actuarial science, architecture, consulting, engineering, health and law) must pay SET on the *entire amount* of their LLC income is clearly unreasonable. I say this because, among other considerations, the rule

is flatly inconsistent with IRS enforcement practice with regard to the FICA liability of individuals who are members of entities taxable as S corporations.

Moreover, I believe that a tax professional may persuasively argue that although, as indicated above, the Prop. Reg. is binding on the IRS under *Elkins*, it is *not* binding on LLC members with regard to any rules it may contain that are unreasonable. Among other considerations:

- By their terms, the *Elkins* authorities address the binding effect of IRS guidelines only as applicable to the IRS, not as applicable to taxpayers.
- Moreover, unreasonable means unreasonable. If an IRS guideline is unreasonable, it cannot stand even if it is set forth in a *final* regulation, not to speak of a regulation that is merely proposed.

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