

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

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**PROTECTING PASSIVE MEMBERS OF LLCs
FROM THE SELF-EMPLOYMENT TAX**

**NINE AMBIGUITIES IN PROP. REG. §1.1402(a)-2
AND HOW TO RESOLVE THEM**

EXECUTIVE SUMMARY. Prop. Reg. §1.1402(a)-2 (the "Prop. Reg.") provides in general:

- That a member of a multi-member LLC taxable as a partnership whose share of LLC income is not otherwise exempt from the Self-Employment Tax (the "SET") under Internal Revenue Code Section 1402 will be exempt from SET on that income only if he or she is a "limited partner" within the meaning of Internal Revenue Code Section 1402(a)(13); and
- That the member will be deemed to be a limited partner under that IRC section only if he or she passes each of four tests.

These four tests may be summarized as follows:

1. The personal liability test. Under the "personal liability" test, the member must not have liability for the LLC's debts solely by reason of being a member.
2. The contract authority test. Under the "contract authority" test, the member must not have authority under the governing LLC act to sign contracts that bind the LLC.
3. The 500-hour test. Under the "500-hour" test, the member must not work more than 500 hours for the LLC during the relevant LLC taxable year.
4. The service member test. Under the service member test, the member must not be a member of an LLC engaged in providing professional services in the fields of accounting, actuarial science, architecture, consulting, engineering, health or law.

Although the above four-part test is easy to apply in most cases, it also contains at least nine important ambiguities. These ambiguities and my views as to how to resolve them are discussed below. In subsequent issues of this newsletter, I will discuss the two key exceptions to the Prop. Reg. four-part test – namely, the "single-class" exception and the "two-class" exception.

DISCUSSION –NINE IMPORTANT AMBIGUITIES IN THE PROP. REG.

- 1) Member-managed LLCs. If, under its certificate of formation as filed with the Secretary of State, the LLC of which an individual is a member is a “member-managed” LLC – i.e., an LLC in which, under the governing LLC act, each member has the legal right to sign LLC contracts that bind the LLC – but the member is in fact entirely passive and will never sign an LLC contract, is the member nevertheless liable for SET on his or her share of LLC income?

My answer. The answer is clearly yes. There are probably many hundreds of New Hampshire LLCs and tens of thousands of LLCs nationwide that have fallen into this SET trap. If your client’s LLC is member-managed but your client is a passive LLC member and wants to avoid SET on his or her LLC income, the LLC in question must immediately amend its certificate of formation to provide that it is manager-managed. And that amendment will help your client only prospectively, not retroactively.

- 2) Guarantors of LLC debt. If a member of an LLC personally guarantees an LLC debt, is the member “personally liable for LLC debt” for purpose of the Prop. Reg. “personal liability” test?

My answer. The answer is probably no. This is because such a member would be liable for entity debt not by reason of being a member under the governing LLC act, but rather, only because of the member’s voluntary determination to sign a guarantee under state contractual law.

- 3) Bookkeepers. Is a bookkeeper an “accountant” for purposes of the “service member” test?

My answer. The answer is probably no. This is because an individual is probably an “accountant” under that test only if he or she is licensed as a CPA or an EA and thus meets an important traditional test for being a member of a profession.

- 4) Veterinarians. Does a veterinarian work “in the field of health” for purposes of the service member test?

My answer. The answer is probably yes, since, although veterinarians provide health care services only to animals, they are nevertheless clearly “professionals” in the traditional sense of the term.

- 5) Medical testing LLCs. Is an LLC that administers medical tests (e.g., blood pressure tests or AIDS tests for insurance companies) a “service” LLC “in the field of health” for purposes of the service member test?

My answer. The answer is probably no, because the members of such LLCs are not normally treated under state law as professionals.

- 6) Proving compliance with the “500-hour test.” What measures should a member take to ensure that he or she meets the “500-hour test?”

My answer. In most cases, the member will not need to keep detailed time records of his or her work for the LLC in question in order to meet this test. Instead, circumstantial evidence – e.g., evidence about the member’s commitment to other work or volunteer activities – will normally suffice to meet the test.

7) Consultants. What is a “consultant” for purposes of the service member test?

My answer. The Prop. Reg. provides no answer to this question, but on this and many other questions under the Prop. Reg., reliable guidance is provided by the personal service corporation regulations under Treas. Regs. section 1.448-1T. Under those regulations, a consultant is defined very broadly as any person who provides “advice and counsel.” *See* Regs. Section 1.448-1T(e)(4)(iv). (The breadth of this definition creates a dangerous SET trap for many LLCs, including, for example, LLCs whose members provide investment counseling but are not stockbrokers.)

8) Mapping and surveying services, etc. If an individual provides mapping services, surveying services and other similar services but lacks an engineering degree as such, is the individual an “engineer” for purposes of the service member test?

My answer. The answer is probably yes. *See* Treas. Regs. section 1.448-1T(e)(4)(i)(C).

9) Stockbrokers. Is a stockbroker a consultant for purposes of the service member rule?

My answer. No. *See* Treas. Regs. Section 1.448-1T(e)(iv).

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