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LLC Members Subject to SE Tax

Cross References

- *Castigliola,* T.C. Memo. 2017-62, April 2, 2017
- IRC §1402(a)(13)

The Tax Court continues to issue rulings on LLC members who are subject to SE tax on their distributive share of profits.

A general partner's distributive share of profits is subject to self-employment (SE) tax. However, a limited partner's share of profits (other than guaranteed payments for services rendered) is not subject to SE tax [IRC §1402(a)(13)]. This code section was written prior to the creation of limited liability companies (LLCs) and limited liability partnerships (LLPs). LLCs and LLPs are state creations that allow partnerships to register as LLCs or LLPs under state law and obtain a degree of limited liability protection for the owners, similar to the limited liability protection available to shareholders of a corporation.

LLC members took the position that their distributive share of profits were not subject to SE tax because they were considered limited partners under state LLC statutes. The IRS took the position that LLC members who were active in conducting business for their partnerships were more like general partners rather than limited partnerships. The IRS issued Proposed Regulation section 1.1402(a)-2(h) which states for the purposes of IRC section 1402(a)(13), an individual is treated as a limited partner unless the individual:

- Has personal liability for the debts of or claims against the partnership by reason of being a partner, or
- Has authority to contract on behalf of the partnership, or
- Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Certain exceptions to these general rules apply, including a provision that states an individual who is a service partner in a service partnership may not be a limited partner, even if the partner performs less than 500 hours during the year.

Then in 1997, Congress enacted the Taxpayer Relief Act of 1997. Under Section 935 of that law, Congress nullified all regulations issued prior to July 1, 1998, dealing with SE tax for LLC members. The IRS never withdrew its proposed regulations, nor did it issue new regulations concerning the SE tax treatment for LLC members. Confusion existed for a time as to whether the proposed regulations were still valid.

The Tax Court first weighed in on the issue in *Renkemeyer, Campbell & Weaver, LLP,* 136 T.C. 137 (a 2011 Tax Court case) where it ruled that the LLP partners' distributive shares were subject to self-employment tax because they were payments for services performed,

even though the partners were limited partners under state limited liability laws.

Then in *Howell,* T.C. Memo 2012-303, an LLC reported guaranteed payments to the LLC members for services rendered. One LLC member tried to reclassify the guaranteed payments as a distributive share of profits, not subject to SE tax. The court ruled the taxpayer may not disavow the form of the transaction as reported on the LLC tax return. It is interesting in this court case what the court did not say. The court did not make a blanket statement claiming LLC members with management control are automatically subject to self-employment tax on their distributive share of profits.

The IRS further clarified in a 2014 Letter Ruling that distributive shares to LLC members who are active in the production of the LLC's earnings are subject to SE tax. (CCA 201436049)

***Castigliola,* T.C. Memo. 2017-62.** A new Court Case ruling further clarifies the SE tax issue for LLC members. The taxpayers were attorneys who originally practiced law through a general partnership. In 2001, they reorganized their law firm as a professional limited liability company (PLLC). Under state law, a PLLC is a type of LLC that may be formed only for the purpose of rendering certain professional services, including legal services. All members must be authorized by law to render the services, and formation of a PLLC requires an additional provision in the certificate of formation electing professional limited liability company status.

The PLLC members were paid guaranteed payments for services rendered. In addition to the guaranteed payments, net profits in excess of the amounts paid out as guaranteed payments were distributed among the members in accordance with the members' agreement. They reported all guaranteed payments as self-employment income subject to SE tax. They reported their distributive share of net profits in excess of their guaranteed payments as income not subject to SE tax.

The IRS argued that the members were not limited partners for the purpose of IRC section 1402(a)(13), and therefore, their distributive share of net profits were also subject to SE tax. The court noted that no statutory or regulatory authority defines "limited partner" for purposes of IRC section 1402(a)(13). Because the term is not defined, the Tax Court applies accepted principles of statutory construction to determine Congressional intent.

The first issue is whether the taxpayer held a position in an entity treated as a partnership that is functionally equivalent to that of a limited partner in a limited partnership. A limited partnership has two classes of partners, general and limited. General partners typically have management power and unlimited personal liability. Limited partners typically lack management power but enjoy immunity from liability for debts of the partnership. Under the Uniform Limited Partnership Act of 1916, "a limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Later revisions of this Act and state provisions allow for certain safe harbors for various activities a limited partner may perform without losing limited liability protection. However, common to the various state laws and revisions concerning the definition of a limited partner are the primary characteristics of limited liability and lack of control of the business.

In this case, the PLLC members each had management power over the business. There was no evidence to show that any member's management power was limited in any way. Each member participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. On the basis of these facts, the PLLC members could not have been limited partners under any of the limited partnership acts. Therefore, they could not be limited partners under IRC section 1402(a)(13).

Another issue is the fact that a limited partnership (as defined under the Uniform Limited Partnership Act) must have at least one general partner who is in control of the business. Because all of the PLLC members had the same rights and responsibilities, they must all have had positions analogous to those of general partners in a limited partnership. This conclusion is supported by the fact that before they formed the PLLC, they operated as a general partnership, not a limited partnership. There was no evidence that organizing as a PLLC changed the way they managed the business. Therefore, they could not exclude any part of their distribute shares from self-employment income under IRC section 1402(a)(13).

Note: Of interest here is the fact that the court said there was no regulatory authority that defines a limited partner for purposes of IRC section 1402(a)(13). The court made no reference to the proposed regulations issued by the IRS prior to the Taxpayer Relief Act of 1997. Therefore, the 500 hour test under Proposed Regulation section 1.1402(a)-2(h) appears to be irrelevant. The court focused on management authority of the partner to determine limited partner vs. general partner status rather than the number of hours spent performing services for the partnership.

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Employer Provided Parking Benefits

Cross References

- IRC §132(a)(5)
- Ltr. Rul. 2017-0007, March 31, 2017

The cost of parking for an employee who commutes to work is generally not deductible. However, IRC section 132(a)(5) states that gross income does not include any benefit that is a qualified transportation fringe. IRC section 132(f)(1)(C) states that qualified transportation fringes include qualified parking. Qualified parking includes parking provided to employees on or near the business work premises. Parking is provided by an employer if:

- The parking is on property that the employer owns or leases,
- The employer pays for the parking, or
- The employer reimburses the employee for parking expenses.

If the employer chooses to reimburse the employee for qualified parking expenses, the employer can do so either by providing the reimbursements in addition to the employee's regular wage, or the employer can provide the reimbursements in place of pay. Reimbursements provided in place of pay are called compensation reduction arrangements. Under compensation reduction arrangements, the employer permits the employees to elect to reduce their taxable compensation in order to receive tax-free reimbursements for parking expenses that the employees have actually incurred.

In a recent IRS Letter Ruling, employees asked the IRS whether amounts deducted from their wages for parking qualified to be excluded from their taxable income as qualified parking benefits.

The employer implemented a parking policy at a location whereby the employer contracted for secure parking for its employees in a parking facility near work. The employer pays the parking vendor directly for the parking spots. Employees who wish to use the secure parking must agree, in writing, to reimburse the employer by having the monthly parking fee deducted from their paycheck in the month prior to using the parking. The employees cannot get a refund of the withheld funds if they do not use the parking. The cost of the parking is less than the statutory limit for qualified parking benefits ($255 per month for tax years 2016 and 2017).

The employees are not given the option of choosing between taxable cash compensation and parking. Accordingly, the employer does not exclude the cost of the parking from the taxable wages of those employees who have elected to use the parking. Instead, the employer simply deducts the cost of the parking from the employee's after-tax wages.

The IRS Letter Ruling state that arrangements where an employer purchases parking spots from a parking vendor and then, in turn, permits employees who wish to use the parking spots to pay the employer for the parking spots using the employees' own after-tax compensation do not meet the definition of qualified parking benefits under IRC section 132(a)(5). Therefore, the amounts deducted from the employee's wages for parking are not excludable from taxable income.

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Termination Payments Subject to SE Tax

Cross References

- *Geneser,* T.C. Memo. 2017-110, June 12, 2017

Self-employment tax (SE tax) generally applies to the net profits earned while carrying on a trade or business as a sole proprietor or general partner in a partnership. IRC section 1402(a) uses the term "carried on," and the courts generally interpret this to mean income earned while the individual is conducting business. Income earned for not carrying on a business, such as income earned under a covenant not-to-compete agreement is generally not subject to SE tax because the individual is being paid to not work (*Milligan,* 9th Cir., 1994). Likewise, income received as a retired partner under a written partnership plan that provides for lifelong periodic retirement payments are not subject to SE tax if the retired partner had no other interest in the partnership and didn't perform services for it during the year.

In this court case, the taxpayer sold insurance as an independent contractor. He received commission advances from the insurance company which created a debit balance and were repaid from his future earned commissions. His contracts with the insurance company included a vesting schedule that was dependent on his length of service with the insurance company. The contract stated all of the commissions earned following the agent's termination date shall be 100% vested if the agent has completed ten years of continuous service.

IRC section 1402(k) says termination payments received by former insurance salesmen are exempt from SE tax if:

1) The payments are received after termination of the individual's agreement to perform services for the insurance company,
2) The individual performs no services for the insurance company after the termination and before the close of the tax year,
3) The individual enters into a covenant not-to-compete against the insurance company which applies to at

least the 1-year period beginning on the date of the termination, and

4) The amount of the payment:
   a) Depends primarily on policies sold by or credited to the account of the individual during the last year of the agreement or the extent to which such policies remain in force for some period after the termination, or both, and
   b) Does not depend to any extent on the length of service or overall earnings from services performed for the company (without regard to whether eligibility for payment depends on length of service).

The court said that in this case, the taxpayer's commission payments credited toward his account were dependent on his length of service with the insurance company. Accordingly, he did not meet the requirements of IRC section 1402(k). Therefore, the termination payments were subject to SE tax.

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Portability Election Simplified Method

Cross References

• Rev. Proc. 2017-34

A decedent is allowed an exclusion amount against the federal estate and gift tax. For decedent's dying in 2017, the inflation adjusted exclusion amount is $5,490,000. This means that for decedent's dying in 2017, lifetime gifts plus the value of assets included in the gross estate up to $5,490,000 are excluded from the federal estate tax. For purposes of the federal estate and gift tax, a portability election allows a surviving spouse to add the decedent's unused estate and gift tax exclusion amount to the surviving spouse's own exclusion amount. For example, if a decedent dies in 2017 with total lifetime gifts and a gross estate of $3 million, the surviving spouse can elect to add $2,490,000 ($5,490,000 minus $3,000,000) to his or her own exclusion amount.

The executor of the estate of the deceased spouse must elect portability of the unused estate and gift tax exclusion amount by filing an estate tax return for the decedent within nine months of the decedent's date of death (plus extensions) and include a calculation of the unused exclusion amount on that return. A return must be filed by the executor to elect portability even if the decedent was not otherwise required to file a federal estate tax return.

Regulation section 301.9100-3 provides relief for executors who fail to make the election by the due date of the return by allowing an extension of time to make the election under certain circumstances. Generally, since December 31, 2014, executors needed to apply via a private letter ruling to request the IRS to grant an extension of time to make the election. As a result of numerous requests for relief, the IRS has issued a new revenue procedure for a new simplified method to make the election.

New simplified method. A new simplified method is available to the executor of the estate of a decedent if:

1) The decedent:
   a) Was survived by a spouse,
   b) Died after December 31, 2010, and
   c) Was a citizen or resident of the United States on the date of death.
2) The executor is not required to file an estate tax return based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes,
3) The executor did not file an estate tax return by the due date of the estate tax return, and
4) The executor satisfies the following requirements:
   a) The executor must file a complete and properly prepared Form 706 on or before the later of January 2, 2018, or the second annual anniversary of the decedent's date of death.
   b) The executor filing the Form 706 states at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)."

If the executor does not satisfy the above requirements, the executor can still request relief by requesting a private letter ruling under the provisions of Regulation section 301.9100-3.

This simplified method does not extend the period during which the surviving spouse or the surviving spouse's estate may make a claim for credit or refund as a result of making the portability election under this revenue procedure.

This simplified portability election procedure is effective June 9, 2017.

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Partnership Audit Regulations

Cross References

• REG-136118-15, June 14, 2017

The Bipartisan Budget Act of 2015 replaced the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) procedures for auditing partnership returns beginning in 2018. The IRS recently issued proposed regulations dealing with the new partnership audit procedures. The following is a summary of provisions contained in the new regulations.

Partnership audit regime. Beginning in 2018, any adjustment made during a partnership audit to items of income, gain, loss, deduction, or credit of a partnership and any partner's distributive share of those adjusted items is assessed and collected at the partnership level. Any penalty, addition to tax, or additional amount that relates to an adjustment made during a partnership audit is also determined at the partnership level.

Election out of centralized partnership audit regime. A partnership can elect out of the centralized partnership audit regime if it has 100 or fewer partners during the year and all partners are eligible partners. Eligible partners include individuals, C corporations, eligible foreign entities, S corporations, or the estate of a deceased partner. A partnership has 100 or fewer partners if it is required to furnish 100 or fewer K-1s during the year. Unlike the TEFRA rules, a husband and wife are not treated as a single partner for purposes of this 100 or fewer partner rule.

By electing out of the centralized partnership audit regime, the IRS must assess and collect additional taxes and penalties at the partner level rather than the partnership level. The proposed regulations detail the procedures for which a partnership can make such election. It is expected that the Form 1065 instructions will also contain the details on how to make such election.

Consistency rule. A partner's treatment of each item of income, gain, loss, deduction, or credit attributable to a partnership must be consistent with the treatment of those items on the partnership return, including treatment with respect to the amount, timing, and characterization of those items. The IRS may assess and collect tax resulting from a partner inconsistently reporting items. The partner may not request an abatement of that assessment. This rule does not apply to items that the partner properly identifies on a statement as being treated inconsistently with the partnership return under the inconsistent treatment rules of IRC section 6222 [see Prop. Reg. §301.6222-1(d) for details].

Partnership representative. The proposed regulations provide rules for how a partnership designates a partnership representative and the authority of that representative. It is expected that the Form 1065 instructions will also contain the details on how to designate a partnership representative.

Imputed underpayment and modification of imputed underpayment. In general, an adjustment at the partnership level may result in an imputed underpayment. The partnership must then pay the imputed underpayment in the adjustment year. The proposed regulations address calculations and modifications of an imputed underpayment and the treatment of adjustments that do not result in an imputed underpayment.

Election for alternative to payment of imputed underpayment. The proposed regulations contain instructions for how a partnership can elect to have the partners pay the imputed underpayment rather than the partnership. If the partnership makes a valid election, the partners and not the partnership are liable for the tax, penalties, additions to tax, and additional amounts plus interest resulting from the imputed underpayment.

Administrative adjustment requests. The proposed regulations contain instructions for how a partnership may file and administrative adjustment request (AAR) with respect to one or more items of income, gain, loss, deduction, or credit, and any partner's related distributive share for a partnership tax year. In general, the partnership and not individual partners may make an AAR.

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