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# Can LLC Members Avoid Self-Employment Tax on LLC Profits?

by James R. Browne

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In this article, Browne argues that a limited liability company member should not be subject to self-employment tax on the member's distributive share of the LLC's profits if the member receives reasonable compensation in the form of a guaranteed payment for any services it provides to or on behalf of the LLC.

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One frequently cited disadvantage of choosing a limited liability company to own and operate a business is the uncertainty of whether self-employment tax is imposed on a member's distributive share of the LLC's profits. To address that uncertainty, tax advisers often suggest electing S corporation status for the business as a more reliable means of mitigating self-employment tax on the owners' shares of the business income while preserving the passthrough character of the entity. The problem with that suggestion is that an S corporation involves significant disadvantages relative to an LLC (which are rarely given adequate consideration), making an S corporation a poor choice of entity for most businesses.[1] There is generally no reason to suffer those disadvantages if an LLC member's distributive share income is exempt from self-employment tax.

This article concludes that, under existing law, an LLC member should not be subject to self-employment tax on the member's distributive share of the LLC's profits if the member receives reasonable compensation, in the form of a guaranteed payment, for any services the member provides to or on behalf of the LLC. Also, several alternative structures for an LLC are presented that should provide greater comfort that the member's distributive share of LLC business income is exempt from self-employment tax under existing law.

Throughout this article, LLC is used to refer to a limited liability company that has more than one member and is classified as a partnership for federal income tax purposes, which is the default classification.[2] Also, the term LLC generally refers to a "manager-managed" LLC, as opposed to a "member-managed" LLC, for which the LLC's members have no authority to enter into contracts on behalf of the LLC or otherwise participate in the management or operations of the LLC in their capacity as members (other than some limited consent rights for extraordinary actions or transactions).

## I. The Conundrum

Suppose two individuals, Andy and Bill, form a company (Newco) to acquire the assets of a widget manufacturing business from Bigco. Andy and Bill expect that Newco will be highly profitable from its inception. With the assistance

[1] *See* James R. Browne, "The Perils of Electing S Corporation Status," Barnes & Thornburg Insights (Mar. 27, 2019).

[2] Reg. section 301.7701-3(b)(1).



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of a corporate lawyer, Andy and Bill organize Newco as a manager-managed LLC with Andy and Bill as the sole members and managers. Andy and Bill will each work full-time for Newco and it will pay them each a salary of $150,000 per year, which represents reasonable compensation for the substantial services they will provide.

Andy and Bill engage an accountant, Sally, to help establish the accounting and tax reporting records for Newco. Sally advises that absent any special tax planning, Newco will be classified as a partnership for tax purposes with the result that all their income from Newco — both salary income and residual profits — will be subject to self-employment taxes. Sally recommends filing an election to have Newco treated as an S corporation for federal income tax purposes.[3] By making the S corporation election, Andy and Bill's salary income will be subject to employment taxes (with generally the same effect as self-employment taxes), but their distributive shares of Newco's residual profits will not be subject to self-employment taxes.

Sally's recommendation that Newco file an S corporation election is predicated on Sally's conclusion that, absent the election (and all its potential ill effects, which Sally fails to mention), Andy and Bill's distributive shares of Newco's residual profits will be subject to self-employment taxes. If, as this article asserts, Sally's conclusion is incorrect or can easily be circumvented, Andy and Bill should reject Sally's recommendation.

## II. Preliminary Analysis

Before a business owner does a deep dive into the advantages and disadvantages of electing S corporation status for an LLC or restructuring the LLC as described in this article, it is critical to first determine whether the election or restructuring will actually achieve any material tax savings. Many advisers reflexively recommend electing S corporation status without carefully analyzing whether the business is generating any material net income. Often, the business is operating at a loss. Or the owners want to pay themselves significant salaries to optimize their contributions to their qualified retirement plans, leaving relatively little residual profits. Only if the business is reliably generating significant taxable income in excess of the desired salary level (not a particularly common situation) would it make sense to pursue planning to mitigate self-employment taxes. Even then, the effective tax savings on the excess earnings is only about 2.5 percent to 3 percent (after accounting for the deduction of half the self-employment taxes). The residual profits (if any) must be relatively high to justify the effort and inconvenience of changing the entity's tax classification or structure.

If the preliminary analysis establishes that the business is or will be reliably generating sufficient residual profits to justify planning to mitigate self-employment taxes, another preliminary question is whether the business should consider converting to a C corporation. This may make sense if the stock can qualify for the gain exclusion benefits provided by section 1202. A discussion of section 1202 is beyond the scope of this article, but a brief discussion of the potential benefits of section 1202 is covered in an earlier article.[4]

The discussion that follows assumes the LLC owners have concluded that the business will generate sufficient residual profits to justify tax planning to mitigate self-employment taxes and that the LLC should not convert to a C corporation for tax purposes.

## III. The Limited Partner Exception

Generally, a partner's distributive share of income from a partnership is subject to self-employment tax.[5] However, in computing income subject to self-employment tax, section 1402(a)(13) provides an exception for some income of limited partners:

> There shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are

[3] *See* IRS Form 2553, "Election by a Small Business Corporation."

[4] *See* Browne, "Choice of Entity for a Startup Business After Tax Reform," Barnes & Thornburg Insights (Aug. 30, 2018).

[5] Section 1402(a).



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established to be in the nature of remuneration for those services.[6]

The limited partner exception was originally enacted to prevent limited partners from affirmatively characterizing distributive share income as earnings from self-employment. At that time, the self-employment tax rate was low relative to the related Social Security benefit accruals. As a result, promoters were marketing limited partner interests in securities trading partnerships as a means of giving investors Social Security credits in addition to their investment returns. The limited partner exception directly targeted those arrangements.[7] While those arrangements typically involved limited partners who performed no services for the partnership, the scope of the statutory language is not limited to purely passive investors. Rather, under the statutory language, the distributive share of income of a limited partner "as such" is exempt from self-employment tax even if the limited partner provides services to the partnership.

Over time, the self-employment tax rate rose relative to the value of the related Social Security credits, and limited partners in profitable partnerships now benefit from the limited partner exception. Yet the statutory language remains unchanged, as does the original congressional intent to broadly prevent distributive share income of limited partners from being characterized as earnings from self-employment.

## IV. Application to LLC Members

LLCs classified as partnerships for tax purposes are considered partnerships, and their members are considered partners, for determining income subject to self-employment taxes under section 1402 and the limited partner exception.[8] Proposed regulations (REG-209824-96) provide that a member in an LLC classified as a partnership is considered a limited partner *unless* the member:

- has personal liability for the LLC's debts by reason of being a member;
- has authority to contract on behalf of the LLC under the law to which the LLC is organized; or
- participates in the LLC's trade or business for over 500 hours during the LLC's tax year.[9]

Substantively identical rules apply to partners in state law partnerships. The proposed regulations make no substantive distinction between partners in state law partnerships and members in state law LLCs.

## V. Dual-Status Partners

Nothing in the statutory text of the limited partner exception indicates that a person who is both a limited partner and a general partner in a partnership is outside the scope of the limited partner exception. Under a plain reading of the statute, (1) the sum of the person's distributive share income in the person's capacity as a *general* partner, plus the person's guaranteed payments for services rendered to the partnership, is subject to self-employment tax; and (2) the person's distributive share income in the person's capacity as a *limited* partner as such is exempt from self-employment tax. By logical extension, in the context of a manager-managed LLC, the distributive share income of an LLC member in the LLC member's capacity as a non-managing member should be exempt from self-employment tax, regardless of whether the LLC member is also

[6] Section 1402(a)(13).

[7] H. Rep. No. 95-57, at 5 (Oct. 31, 1977).

[8] Prop. reg. section 1.1402(a)-2(f), REG-209824-96 (Jan. 13, 1997) ("the same standards apply when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC"); *Hardy v. Commissioner*, T.C. Memo. 2017-16 (non-managing member interest in an LLC classified as a partnership for tax purposes is eligible for the limited partner exception). The treatment of LLCs and LLC members in the proposed regulations is consistent with the treatment of LLC members for purposes of the passive activity loss rules, which impose on limited partners a more restrictive test for material participation. *See* section 469(h)(2); prop. reg. section 1.469-5(e)(3), REG-109369-10 (Feb. 28, 2011).

[9] Prop. reg. section 1.1402(a)-2(h)(2). The test in the proposed passive activity loss rules considers only whether the holder has a right to manage the entity. *Supra* note 8.



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a manager of the LLC and has authority to contract on behalf of the LLC in that capacity (as long as the member receives reasonable compensation for the services provided as a manager).

The proposed regulations generally reach a contrary result. The general rule of the proposed regulations is that an individual who is both a member and a manager of an LLC cannot qualify as a limited partner because the rights as a manager to contract for the partnership violates the second of the three requirements for limited partner status.[10] There is one narrow exception to this general rule: If the individual's rights as a manager are represented by a separate class of interest in the LLC,[11] the individual is treated as a limited partner with respect to the member interest if, immediately after the individual acquires the member interest (1) other members meeting the three requirements for limited partner status own 20 percent or more of the member class interests;[12] and (2) the individual's rights and obligations regarding the member interest are identical to the rights and obligations of the member interests held by the qualifying limited partners.[13] Neither the statute nor its legislative history provides any support for the proposed regulations' classification of a member's rights as a manager as being a single class of interest in the LLC, or the proposed regulations' focus on the rights of other members when classifying a manager's membership interest.

[10]Prop. reg. section 1.1402(a)-2(i), Example (iv). The example concludes that individual C's interest in the LLC as a member and interest in the LLC as a manager constitute a single class of interest.

[11]The proposed regulations state that "a class of interest is an interest that grants the holder specific rights or obligations," and that a separate class of interest exists when "a holder's rights and obligations from an interest are different from another holder's rights and obligations." The rights and obligations of a manager are, by definition, different from the rights and obligations of a member. However, the example cited in footnote 10 concludes that a member elected as the LLC's manager holds a single class of interest in the LLC. Therefore, there seems to be something extra required to create a separate class of interest, but the proposed regulations are not clear on what extra is required. Presumably, a manager interest formally designated as a separate class of interest coupled with a share of LLC profits (or capital and profits) is sufficient.

[12]The actual test is that qualifying limited partners own "a substantial, continuing interest," and the determination is based on all the facts and circumstances. But for this purpose, in all cases, ownership of 20 percent or more of a class of interest is considered substantial. Prop. reg. section 1.1402(a)-2(h)(6)(iv).

[13]Prop. reg. section 1.1402(a)-2(h)(3).

A strong argument can be made that, based on the text of the statute and its original purpose, an LLC member's rights as a member, and rights as a manager, in a manager-managed LLC constitute separate rights, and that distributive share income attributable to the member interest qualifies for the limited partner exception (regardless of whether there are any other owners of the member interests or their separate rights as managers). Alternatively, if the LLC can be structured so that (1) the manager interest is represented by a separate class of interest, and (2) more than 20 percent of the member interests are held by qualifying limited partners, the LLC member's distributive share income attributable to the member interest qualifies for the limited partner exception under the proposed regulations.[14]

## VI. Service Partners

Under section 1402(a)(13), the distributive share income of a limited partner as such is exempt from self-employment tax even if the limited partner renders services to or on behalf of the partnership. Implicitly, if the limited partner provides services to or on behalf of the partnership, the limited partner must be compensated for those services, generally in the form of guaranteed payments, and the guaranteed payments or other compensation must represent at least reasonable compensation for the services rendered.[15] This reading of the law makes sense. To the extent the limited partner receives reasonable compensation for services rendered to or on behalf of the partnership, any residual profits allocated to the limited partner necessarily represent earnings from factors other than self-employment.[16] If the limited partner does not receive reasonable compensation for

[14]Applicable IRS procedures indicate that the IRS "ordinarily should not take any position in litigation or advice that would yield a result that would be harsher to the taxpayer than what the taxpayer would be allowed under the proposed regulations." Internal Revenue Manual section 32.1.1.2(3) (Aug. 2, 2018).

[15]*Joly v. Commissioner*, T.C. Memo. 1998-361 (S corporation must pay reasonable compensation to shareholders who provide services to the corporation).

[16]If the business has no material tangible or intangible assets and no employees (other than the limited partners), the reasonable compensation (guaranteed payments) paid to the limited partners will generally leave little or no distributive share income. This is equally true for an S corporation.



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services rendered to or on behalf of the partnership, the residual profits are presumed to be earnings from those services.[17]

The proposed regulations accept the proposition that a limited partner who participates in the partnership's business (other than some service businesses[18]) can qualify for the limited partner exception, provided the limited partner participates in the business for not more than 500 hours during the partnership's tax year.[19] Under those circumstances, the limited partner's distributive share income is exempt from self-employment tax, but presumably only if the limited partner receives reasonable compensation for any services provided under the 500-hour limitation. If the limited partner participates in the partnership's business for over 500 hours, under the proposed regulations the limited partner is no longer considered a limited partner and is no longer eligible for the limited partner exception for any distributive share income. The logical foundation for the 500-hour limitation is difficult to discern, and the limitation finds no support in the statutory language. Taxpayers would seem to have substantial authority for disregarding the arbitrary 500-hour limitation in the proposed regulations.[20]

The proposition that a limited partner (or LLC member) can recognize both earnings from self-employment and exempt business profits from a partnership or LLC is consistent with the treatment of partnership earnings in the context of the exclusion in section 911 for foreign earned income. Section 911(d)(2)(B) provides:

> In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.[21]

Although section 911 relates to an exclusion from tax for earnings from personal services, whereas section 1402 imposes tax on those earnings, section 911 supports the general proposition that a person can have both earned income and unearned income from a single partnership.[22]

In the 2011 *Renkemeyer* case,[23] the Tax Court held that a general partner in a general partnership was not a limited partner for purposes of the limited partner exception. In reaching this rather obvious conclusion, the court stated that the exception for distributive share income of a limited partner applies only to a partner who is a mere investor and does not perform any services for the partnership:

> The intent of section 1402(a)(13) was to [exclude] individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations. . . . The legislative history of section 1402(a)(13)

[17] A taxpayer might argue that only the portion of the residual profits representing reasonable compensation for services rendered constitutes net earnings from self-employment, and the remainder constitutes income eligible for the limited partner exception. The IRS is likely to reject any such attempted bifurcation of the distributive share income. *See* ILM 201436049 (LLC members subject to self-employment tax on distributive share income without regard to the facts that they: (1) were paid salaries and guaranteed payments for services they provided to the LLC, and (2) contributed capital and employee labor were material income-producing factors for the LLC). *See also Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), and *Complex Media Inc. v. Commissioner*, T.C. Memo. 2021-14 (a taxpayer has a heavy burden in disavowing the form of a transaction).

[18] *See* prop. reg. section 1.1402(a)-2(h)(5).

[19] Prop. reg. section 1.1402(a)-2(h)(2)(iii).

[20] When the proposed regulations were issued in 1997, the 500-hour limitation, together with the limitation for limited partners in some service businesses, triggered "a firestorm of opposition" that led to a one-year legislative moratorium on finalizing the regulations, and a Senate resolution that Congress, not the IRS or Treasury, should determine the law governing self-employment income. As a result of that backlash, the proposed regulations were never finalized, and the IRS has scrupulously avoided issuing any further guidance on the subject (although the IRS has also never withdrawn the proposed regulations). *See* James B. Sowell, "Partners and the SECA Tax: LLC Members and Beyond," 43 *Tax Mgmt. Mem*. 347 (Aug. 26, 2002).

[21] *See also* Rev. Rul. 78-306, 1978-2 C.B. 218 (same rule for determining personal services income from a partnership, applied in the context of the maximum tax rate on personal service income under former section 1348).

[22] *See also Brinks Gilson & Lione v. Commissioner*, T.C. Memo. 2016-20 at 15 ("Respondent claims that amounts paid to shareholder employees of a corporation do not qualify as deductible compensation to the extent that the payments are funded by earnings attributable to the services of nonshareholder employees or to the use of the corporation's intangible assets or other capital. Instead, says respondent, amounts paid to shareholder employees that are attributable to those sources must be nondeductible dividends.").

[23] *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011).



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does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.[24]

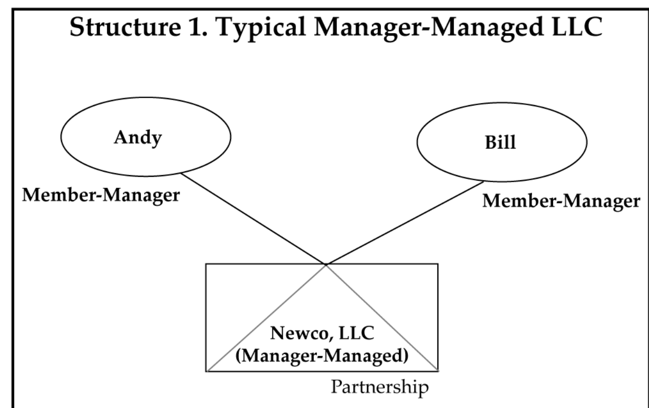
The Tax Court's view regarding the proper scope of the limited partner exception — which this article refers to as the mere investor test — in addition to being irrelevant to the resolution of the case and of no precedential effect, is at odds with the statute, the proposed regulations (which allow for up to 500 hours of service by a limited partner), and analogous provisions of the IRC (such as section 911). Nevertheless, the IRS adopted the mere investor test in two subsequent private rulings.[25]

Given the unambiguous language of the statute, the lack of any precedential legal authority supporting the mere investor test, and the legal and logical flaws of that test, taxpayers are justified in rejecting the mere investor test as a proper interpretation of the scope of the limited partner exception and should not be subjected to any accuracy-related penalty for doing so.[26]

## VII. Structuring Options

The discussion that follows first presents a typical LLC structure as point of reference. Although there is a persuasive argument that the LLC members in that typical structure should not be subject to self-employment on their distributive share income, it is also true that the IRS is likely to challenge that conclusion if the issue is audited. Therefore, several alternative structures are presented that should circumvent any such IRS challenge and should more clearly insulate the LLC member's distributive share income from self-employment tax.

### A. Structure 1 — Typical LLC




Structure 1 reflects the structure that Andy and Bill used in the example at the beginning of this article. Newco is organized as a manager-managed LLC and is classified as a partnership for federal income tax purposes (its default classification). Andy and Bill are the sole members of Newco in which capacity they have no rights to participate in the management of Newco. Andy and Bill are also appointed as managers of Newco, in which capacity they have the exclusive rights to manage Newco's business. Andy and Bill are each paid a salary (in the form of a guaranteed payment) for the services they provide to Newco as Newco's managers, and Newco's residual profits are reported to them on a Schedule K-1 in their capacities as members.

As dual-status partners, Andy and Bill's distributive share of Newco's residual profits should be exempt from self-employment taxes under the limited partner exception provided the salaries paid to each of them constitute reasonable compensation for the services they provide to Newco in their capacities as managers. Andy and Bill are equivalent to partners in a limited partnership in which they hold both a general partner interest and a limited partner interest, and the limited partner interest should qualify for the limited partner exception.

However, if the arrangement is audited by the IRS, the IRS will likely assert that Andy and Bill are not within the scope of the limited partner exception and must pay self-employment tax on their distributive share income, because (1) they

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[24] *Id.* at 150.

[25] *See* ILM 201436049 and ILM 201640014. The *Renkemeyer* opinion has been cited favorably regarding the mere investor test in several subsequent trial court decisions. *Riether v. United States*, 919 F. Supp. 2d 1140 (D.N.M. 2012); *Howell v. Commissioner*, T.C. Memo. 2012-303; *Hardy v. Commissioner*, T.C. Memo. 2017-16; *Castgliola v. Commissioner*, T.C. Memo. 2017-62; *Joseph v. Commissioner*, T.C. Memo. 2020-65; and *Duffy v. Commissioner*, T.C. Memo. 2020-108. In each of the cases in which the taxpayer failed to qualify for the limited partner exception, the failure was for reasons other than the taxpayer rendering services to the partnership. Therefore, none of the cases constitutes relevant or persuasive legal authority in support of the mere investor test.

[26] *See* reg. section 1.6662-4(d)(3)(ii) ("a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision").



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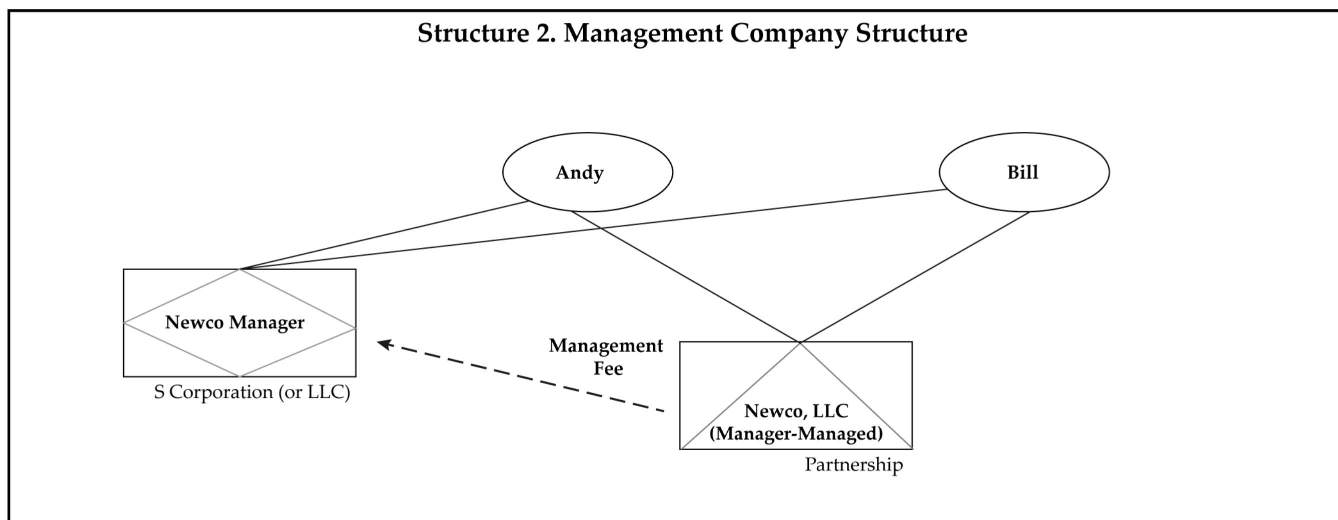


have authority to contract on behalf of Newco under the law under which Newco is organized, and (2) they fail the mere investor test. Although Andy and Bill have strong arguments to repel any such IRS assertion, they might choose instead to adopt a different structure that is more clearly within the scope of the limited partner exception.

## B. Structure 2 — Management Company

In this structure, as in Structure 1, Andy and Bill are the sole members of Newco. However, unlike in Structure 1, Andy and Bill are not Newco managers. Instead, the sole manager of Newco is a separate management company, Newco Manager, which has the exclusive right to manage Newco's affairs.[27] Andy and Bill do not provide any services to Newco, or otherwise participate in Newco's business, in their capacities as members, and the Newco operating agreement expressly states that the Newco members have no authority to contract on behalf of Newco or otherwise participate in the management or control of Newco.

Newco Manager is compensated for its services as Newco's manager under a management agreement. Andy and Bill are the sole owners and employees of Newco Manager. Newco Manager pays Andy and Bill each an annual salary (or, if Newco Manager is organized as an LLC, an annual guaranteed payment) of $150,000 for the services they provide to or on behalf of Newco Manager. The management fee paid by Newco to Newco Manager is approximately equal to (but not less than) Newco Manager's costs of compensating Andy and Bill (including all payroll taxes) plus Newco Manager's other operating costs (which should be minimal).

Under this structure, assuming Andy and Bill's salary or other compensation received from Newco Manager constitutes reasonable compensation for the services they provide to Newco Manager, their distributive share of Newco's residual profits (after payment of the management fee) should be within the scope of the limited partner exception and exempt from self-employment tax. In particular, Andy and Bill, as members, do not have any authority to contract for Newco and do not provide any services to Newco, so they qualify as limited partners under the proposed regulations. Also, because they do not provide any services to Newco in their capacities as members, they should qualify as mere investors in Newco. As a result, even under the Tax Court's and IRS's baseless mere investor test, Andy and Bill should satisfy the requirements for the limited partner exception.

Note that for purposes of the net investment income tax, Andy and Bill should be able to take

[27] Many LLC agreements give the members the right to approve specific extraordinary actions (like a liquidation of the LLC or a business combination). These approval rights, which are like common shareholder approval rights for extraordinary corporate actions, should not cause the members to be deemed to have the right to contract for the LLC or participate in the LLC's business, or otherwise cause the members to be more than mere investors in the LLC.



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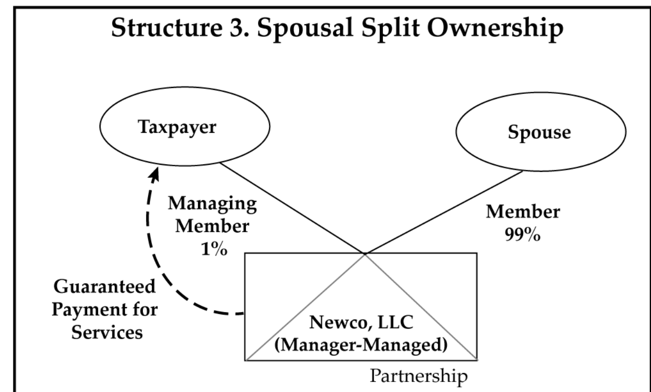
into account their indirect participation in Newco's business in their capacities as employees of Newco Manager in determining whether they materially participate in Newco's business. If they each provide services for the benefit of Newco for more than 500 hours each year in their capacities as employees of Newco Manager, they should be viewed as materially participating in Newco's business such that their distributive share income from Newco is active business income exempt from the net investment income tax.[28]

The position that Structure 2 insulates Andy and Bill's distributive share income from self-employment tax is not necessarily bulletproof and may be less effective for some types of businesses.[29] But given the significant disadvantages of S corporation status, and the often minor self-employment tax benefits at risk, many business owners will be willing to accept the risk of an IRS challenge to Structure 2.

## C. Structure 3 — Spousal Ownership




This diagram presents another structure that should circumvent the mere investor test and exempt substantially all the distributive share income from self-employment tax in accordance with the proposed regulations. In this structure, the taxpayer's spouse receives substantially all the distributive share income from Newco. If the spouse provides no services to Newco and has no management rights as a Newco member, the spouse's distributive share income should be exempt from self-employment taxes under both the proposed regulations and the mere investor test. At the same time, to determine whether the spouse materially participates in Newco's business (so that the spouse can avoid net investment income tax on the distributive share income), the spouse can treat the taxpayer's material participation as material participation by the spouse.[30]

The taxpayer's guaranteed payments would be subject to self-employment tax. The taxpayer's 1 percent distributive share income should not be subject to self-employment tax, but the tax cost of that position being successfully challenged by the IRS is limited to 1 percent of the distributive share income.

If the spouse provides any non-trivial services to Newco, as long as those services total no more than 500 hours per year, and the spouse receives a guaranteed payment for those services representing reasonable compensation for the services provided, the spouse should not be subject to self-employment tax on the net

[28] *See* section 1411(c)(2) (net investment income tax applies to income derived from a business that is a passive activity or trading in financial instruments or commodities); section 469(c)(1)(B) (passive activity is any business in which the taxpayer does not materially participate); reg. section 1.469-5T(a), (e)(2) (material participation test for limited partners); reg. section 1.469-5(f)(1) ("any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.").

[29] A situation in which Structure 2 might not be viable is when Newco's business consists solely of providing services performed by Andy and Bill, and neither capital nor other employees are material income-producing factors. In that case, the IRS is likely to argue that the reasonable compensation to Andy and Bill must account for all or substantially all the LLC's business profits. However, in that case an S corporation is unlikely to provide any better result. *See, e.g., Veterinary Surgical Consultants PC v. Commissioner*, 117 T.C. 141 (2001). The taxpayer might counter that goodwill or other intangibles are material income-producing factors that are properly attributed some portion of the LLC's income. This argument might be supported by provisions in the management agreement with Newco Manager establishing Newco's rights to ownership and exploitation of those intangibles.

[30] Reg. section 1.469-5T(f)(3).



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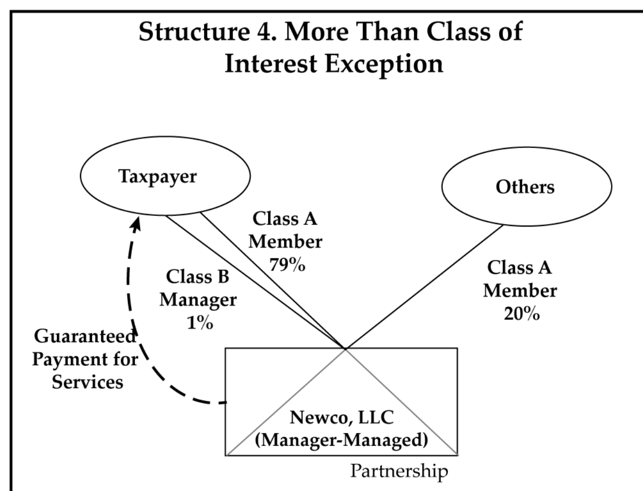
distributive share income. Although that arrangement will violate the mere investor test, it should still be protected under the proposed regulations.[31]

### D. Structure 4 — Multiple Interests




Structure 4 is designed to come within the exception in the proposed regulations for holders of more than one class of interest.[32] Under the exception, if the taxpayer owns more than one class of interest in Newco, the taxpayer is treated as a limited partner with respect to a specific class of interest if, immediately after the taxpayer acquires that class of interest, other non-managing members own a substantial, continuing interest in that specific class of partnership interest and the taxpayer's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the other non-managing members.[33] For this purpose, ownership of 20 percent or more of a specific class of interest is considered substantial.[34]

If persons other than the taxpayer (who might be family members or others who do not provide more than 500 hours of service to Newco in any year) acquire 20 percent or more of the Newco non-managing class A membership interests on the same terms and at the same time as the taxpayer acquires not more than 80 percent of the class A membership interests, and if the taxpayer's rights as manager are reflected in a separate class of interest (the class B membership interest) having at least a 1 percent share of capital and profits,[35] the taxpayer's distributive share income from the class A membership interest should be exempt from self-employment tax. The distributive share income from the class B membership interest will likely be subject to self-employment tax, but incurring that tax should be a small cost relative to the significant potential disadvantages of operating the business as an S corporation.

### E. Other Structures

An LLC structure that is sometimes proposed as a means of mitigating self-employment tax on an LLC member's distributive share income is holding the LLC membership interest in an S corporation.[36] This arrangement has some potentially significant flaws. There are risks that the structure might be disregarded for lack of a significant nontax business purpose or might be ineffective because of the lack of any other assets or employees in the S corporation to justify paying less than all of the corporation's income to the shareholder as compensation.[37] Also, even if the structure is respected and viable, the individual's economic interest in the LLC is stuck inside a corporation. Therefore, the interest cannot be removed from the S corporation without triggering gain, and neither the interest nor the underlying LLC assets receive a stepped-up tax basis if the individual dies owning the interest

[31] Prop. reg. section 1.1402(a)-2(h)(2)(iii). *See supra* note 14 regarding reliance on IRS proposed regulations.

[32] Prop. reg. section 1.1402(a)-2(h)(3).

[33] *Id.*

[34] *Id.*

[35] There is a risk that the IRS might seek to disregard a class of interest having a less than 1 percent share of all partnership tax items. *See* Rev. Proc. 74-17, 1974-1 C.B. 438; Rev. Proc. 2020-12, 2020-11 IRB 511.

[36] *See* discussion in Sowell, *supra* note 20, at 347 n.93.

[37] *Id. See generally* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 2.07 (7th ed. 2015; rev. 2020) (IRS attacks on personal service corporations). In contrast to the LLC *member* S corporation structure discussed in text, an LLC *manager* S corporation structure (such as Structure 2) should not be susceptible to attack for lack of a substantial nontax business purpose because the S corporation in Structure 2 acts as the manager of the LLC, and it is common to isolate the liabilities associated with that function in a separate management company. Similarly, because all the S corporation manager's income is paid to the shareholders as compensation for services, there is no S corporation residual income to be recharacterized as compensation for services.



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through the S corporation. For these reasons and others,[38] organizing an S corporation to hold an LLC member interest is typically an inferior solution relative to Structure 2.

Another LLC structure that has been proposed is holding the employees and operating assets of the business in a separate company (Holdco) owned by the Newco owners, and then have Holdco lease its assets and charge out its employees to Newco.[39] The Newco owners' distributive share of Newco income would be fully subject to self-employment taxes, but their distributive share of Holdco income would be exempt from self-employment taxes if the owners did not participate in the management of Holdco. In effect, the owners are structurally bifurcating the income from their services to Newco and the income from the business's assets and employees in Holdco. That structure seems overly complex, and it might not be realistic to expect that the owners can refrain from participating in the management of Holdco. The structure does not appear to provide any obvious advantages over Structure 2.

## VIII. Conclusion

Under the plain language of section 1402(a)(13), an LLC member should not be subject to self-employment tax on the member's distributive share of the LLC's profits if the member receives reasonable compensation, in the form of a guaranteed payment, for any services the member provides to or on behalf of the LLC. This conclusion is consistent with congressional intent to restrict net earnings from self-employment to actual earnings from services rendered, and exclude earnings from capital, employees, and other factors. There are no precedential legal authorities that contradict this conclusion.

The IRS has refused to accept the conclusion stated in the preceding paragraph. It has been applying a legally unsupported mere investor test to assert that self-employment taxes attach to all distributive share income of partners and LLC members who provide any services to the partnership or LLC. Many advisers recommend a drastic response — electing S corporation status for the LLC — without ever quantifying the benefits or carefully considering the associated disadvantages. Given the speculative and often negligible self-employment tax savings that result from electing S corporation status, the significant potential disadvantages of being an S corporation, the infirmities of the mere investor test, and the ability to structure an LLC to minimize or eliminate the risk of IRS challenge, electing S corporation status is rarely advisable. ■

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[38] One other possible reason to avoid the LLC member structure is the prohibition on an S corporation shareholder taking corporate liabilities into account in determining the shareholder's ability to deduct the shareholder's allocable share of losses from the S corporation. In most cases, the at-risk rules in section 465 will limit an LLC member's ability to deduct the losses, but that will not always be the case. *See* section 465(b)(6) (qualified nonrecourse financing exception). Another reason to avoid the LLC member structure is the propensity of shareholders to inadvertently terminate the S corporation election (potentially triggering double tax on the residual earning) and to fail to observe the corporate formalities necessary to sustain the existence of the S corporation.

[39] *Id.* (reference to Burgess J.W. Raby and William L. Raby, "New Incentive for Avoiding SE and FICA Tax," *Tax Notes*, Dec. 10, 1998, p. 1389).



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