REPORT #856

TAX SECTION

New York State Bar Association

COMMENTS ON PROPOSED REGULATIONS RELATING TO
SELF-EMPLOYMENT TAX TREATMENT OF LLC MEMBERS

November 16, 1995

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October 5, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20200

The Honorable Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Proposed Regulations Relating to Self-Employment Tax Treatment of LLC Members

Dear Secretary Samuels and Commissioner Richardson:

Enclosed please find a report commenting on Proposed Regulations relating to the Self Employment tax treatment of members of LLCs. The author of the report is Roger L. Baneman, Co-Chair of our Committee on Pass-Through Entities.

We have in the past commented on aspects of this issue. In our letter to you of December 9, 1994, regarding tax issues for professional LLCs and LLPs, we expressed the view that the imposition of selfemployment taxes on members of professional LLCs and LLPs should not depend on the members' personal liability (or lack thereof) for entity debts, but instead should depend on whether the members' shares are derived from their performance of services. In our Report No. 811, dated December 9, 1994, we advocated an across-the-board revision of the

self -employment tax treatment of members of pass-through entities, based again on their performance of services.

We realize that in the present context it is not possible to implement a complete overhaul of the taxation of members of pass-through entities, and that regulations prescribing the taxability of members of LLCs must therefore be consistent with the existing statute. We support the imposition of self-employment taxes on members of LLCs whose distributive shares represent earnings from work. We also support limiting the self-employment tax exemption for "limited partners" to those LLC members who are not managers of the LLC.

We do not, however, support the further requirement that a non-managing member demonstrate that the LLC could have been formed as a limited partnership and that the member could have qualified as a limited partner under applicable state law. We believe that this rule has only limited utility as a practical matter. We also believe this rule would inappropriately tie the imposition of federal taxes to hypothetical determinations of how state laws might apply to entities that are not, in fact, subject to such laws; and that the reasons that today suggest the merits of this linkage are likely to diminish, and may become entirely invalid, as taxpayers increasingly turn to the use of limited liability vehicles.

We also suggest that the regulations address more directly the treatment of members of LLPs, and deal as well with the treatment of members of LLCs who elect to assume liability for the entity's debts.

We thank you for this opportunity to comment.

Very truly yours,

Carolyn Joy Lee
Chair

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMENTS ON PROPOSED REGULATIONS RELATING TO SELF-EMPLOYMENT TAX TREATMENT OF LLC MEMBERS

November 16, 1995

We have the following comments on proposed Treasury Regulation Section 1.1402(a)-18 (the "Proposed Regulation"), relating to the self-employment tax treatment of limited liability company ("LLC") members.[1]

Background.

The Self-Employment Contributions Act ("SECA") imposes a tax on an individual's self-employment income. The tax is currently composed of:

(i) a 12.4% Old Age, Survivors and Disability Insurance ("OASDI") tax on the first $61,200 of the individual's self-employment income; plus

(ii) (ii) a 2.9% Medicare Hospital Insurance ("HI") tax on the individual's entire self-employment income.

One-half of the self-employment taxes are deductible for Federal income tax purposes. These self-employment taxes are the analog,

[1] The principal author of this comment is Roger J. Baneman. Helpful comments were provided by Thomas J. Carlson, Peter v.Z. Cobb, Arthur A.

in the self-employment context, of the Federal Insurance Contributions Act ("PICA") taxes with respect to wages.

Section 1402(b) defines self-employment income as an individual's net earnings from self-employment ("NESE"), with certain exceptions. Section 1402(a)generally defines NESE, with exceptions, as the gross income derived by an individual from any trade or business carried on by such individual, less attributable deductions, plus his or her distributive share of "bottom line" income or loss from any trade or business carried on by a partnership of which he or she is a member.

Section 1402(a)(l) excludes from NESE certain items of passive income such as certain interest, dividends and real estate rental income. Section 1402(a)(13) excludes from NESE the distributive share of a limited partner, other than Section 707(c) guaranteed payments to that partner as remuneration for services actually rendered to or on behalf of the partnership. The statute and current regulations do not, however, address the application of the self-employment tax to members of an LLC.

Proposed Treasury Regulation Section 1.1402(a)-18 addresses the selfemployment tax treatment of LLC members. Under the Proposed Regulation:

> (i) except as otherwise provided in Section 1402(a) (for example, for certain interest, dividends and real estate rental income), an individual's NESE includes the individual's distributive share of income or loss from any trade or business carried on by an LLC of which the individual is a member; and

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Feder, Carolyn Joy Lee, Robert J. Levinsohn, Richard L. Reinhold and Eugene L. Vogel.

(ii) an LLC member will be treated as a limited partner for purposes of Section 1402(a)(13) (and therefore the member's distributive share will not be treated as NESE unless it is a guaranteed payment for services) only if:

(a) the member is not a manager of the LLC; and

(b) the entity could have been formed as a limited partnership rather than as an LLC in the same jurisdiction, and the member could have qualified as a limited partner in that limited partnership under applicable law.

For purposes of the Proposed Regulation, an "LLC" means an organization that (i) is formed under a law that allows the limitation of the liability of all members for the organization's debts and obligations within the meaning of Treas. Reg. § 301.7701-2(d) and (ii) is classified as a partnership for Federal tax purposes; a "member" means a person who owns an interest in the LLC; and a "manager" means a person who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the LLC's business. If there are no elected or designated managers, each member will be treated as a manager for purposes of the regulation.

Summary of Recommendations.

We support the general approach of the Proposed Regulation which treats an LLC member as a limited partner eligible for exemption from self-employment tax on his or her distributive share of the LLC's income only if the

member is not a manager of the LLC (the "Manager Rule").[2] However, with respect to the additional requirement that the LLC could have been formed as a limited partnership under local law and the member could have been a limited partner under that law (the "Could-Have-Been-LP Rule"), while we recognize the merits of creating NESE rules for LLCs that closely resemble the rules applied to limited partnerships, we also believe that, in practice and over time, this rule will be difficult to apply and will lead to anomalous results. We therefore believe that the Could-Have-Been-LP I Rule should be eliminated.

Discussion.

The Manager Rule. The Manager Rule, which essentially equates managing members with general partners and non-managing members with limited partners, is simple to state and generally simple to apply. An LLC operating agreement can be, and usually is, drafted in such a manner as to make quite clear which members are managers and which are not. Although it is conceivable that there could be gray areas—for example, an agreement which gave a member the powers of a manager in substance without designating the member as a manager in name—in the great majority of cases the distinction between managing members and non-managing members is made quite clear.

[2] This statement of the Proposed Regulation is a slight oversimplification since, consistent with Section 1402(a)(13), a non-manager member of an LLC would be subject to self-employment tax on Section 707(c) guaranteed payments to the member as remuneration for services actually rendered to or on behalf of the LLC.

One aspect of the definition of "manager" in the Proposed Regulation should be clarified, however. "Manager" is defined to mean a person who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the LLC's business. In keeping with the goal of treating managing members as equivalent to general partners, the definition of manager should also require that a manager have the power to bind the LLC in a manner analogous to a general partner's power to bind the partnership. This would serve to distinguish members who, like limited partners, have consent rights as to certain issues (and who should not, simply as a result of having such rights, be viewed as managers akin to general partners) from members who actually have the power to manage the LLC's business by acting on behalf of the LLC.

The treatment of a managing member essentially as a general partner and a non-managing member essentially as a limited partner for employment tax purposes is consistent with the approach used by the Service in the entity classification area. In Rev. Proc. 95-10, 1995-3 I.R.B. 20, the managing members are essentially treated as general partners in the analysis relating to continuity of life and free transferability of interests. Under the Revenue Procedure, the Service will generally rule that an LLC will lack continuity of life if the LLC dissolves on the happening of the dissolution events with respect to only the member-managers. Rev. Proc. 95-10, Section 5.01(1). Also, if the transfer of sufficient interests in the LLC cannot be made without the consent of a majority of the non-transferring member-managers, the Service will generally issue a ruling that the LLC lacks free transferability of interests. *Id.* Section 5.02(1). Accordingly, there is

precedent for the Service's approach of equating member-managers with general partners.

The Manager Rule is thus simple, straightforward to apply, and analogous to the Service's approach hi the entity classification area. That said, there remains an issue whether the Service should adopt a different approach that produces a more "correct" result.

There often is a tension in tax administration between providing a simple (or consistent) rule and reaching the theoretically correct result. In this case, the "correct" approach would be to treat an LLC member's distributive share of the LLC's income or loss as NESE to the extent such share was compensation for the member's services, but not to the extent such share represented a return on the member's capital.[3] As set forth in our "Report on the Self-Employment Tax as Applied to Owners of Interests in Pass-Through Entities"

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[3] As illustrated by the legislative history, this clearly was the analysis that informed Congressional enactment of the NESE limited partnership rule in 1977:

> "Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work."

H.R. Rep. No. 702, Part I, 95th Cong., 1st Sess. 40-41 (1977). While the governmental interest in the correct classification of limited partners and their ilk has shifted from a concern that investors not be brought within the system to a concern that service providers not be left out, the essential inquiry nevertheless is distinguishing investment returns from "earnings from work."

dated December 9, 1994 (reprinted in Highlights and Documents (December 16, 1994) at 3419), we strongly believe that the NESE rules for all pass-through entities (including partnerships, LLCs and S corporations) should be uniform, and that these rules should be based on an analysis of whether (and to what extent) the owner provides services. While there are practical problems in measuring the portion of a member's distributive share that is attributable to his or her services and the portion that is attributable to a return on his or her capital, on balance we believe that this is the appropriate inquiry and should be consistently incorporated into the NESE rules affecting pass-through entities.

In the present context, however, we are not dealing with a general overhaul of the NESE tax system, but rather with the need for regulations that apply the existing NESE statute to the new LLC form of business entity. Given the original concerns underlying the statute as to whether a partner's distributive share represents earnings from work, we believe that Treasury has the authority to create an LLC NESE rule under which LLC members would, without regard to their labels or their authority, be subject to the NESE regime to the extent their distributive LLC shares represented compensation for services. We recognize, however, that this would introduce yet another set of NESE rules for pass-through entities and would further complicate this area by creating NESE tax disparities between LLC's and limited partnerships.

For these reasons, while we continue to believe that this entire area should be examined and revised, we also recognize the benefits of adopting, in the interim, a NESE rule for LLC's that generally corresponds to the existing treatment of limited partnerships. We therefore support the Proposed Regulations' Manager Rule.

Could-Have-Been-LP Rule. Even as to non-managing members, under the Could-Have-Been-LP Rule, the Proposed Regulation permits an LLC member to be treated as a limited partner for purposes of Section 1402(a)(13) only if (i) the entity could have been formed as a limited partnership rather than an LLC hi the same jurisdiction and (ii) the member could have qualified as a limited partner in that limited partnership under applicable law. The preamble to the Proposed Regulation states that the purposes of these requirements are (i) to prevent a business from obtaining a self-employment tax benefit by operating through an LLC rather than through a limited partnership and (ii) to cause an LLC member who participates in the management or control of the entity to be treated in the same manner as a limited partner who participates in the management or control of the entity (i.e., as a general partner). See 59 F.R. 67254 (Dec. 29, 1994).

The perceived abuse is apparently that a non-managing member of an LLC might participate in the management or control of the LLC to such an extent that he or she could not have been a limited partner if the LLC had been organized as a limited partnership, yet under the LLC form would enjoy the NESE exclusion of section 1402(a)(13).

We question whether this is an "abuse" and, in any event, we do not believe that the potential for such situations justifies the complexity and compliance burden of the Could-Have-Been- LP Rule.

For example, under the Revised Uniform Limited Partnership Act("RULPA"), a limited partner who is not also a general partner is not liable for the obligations of the limited partnership if the limited partner does not participate in the control of the business. See RULPA Section 303(a) (1976 version with 1985 amendments). Even if the limited partner does participate in the control of the business, the limited partner is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner. IdL Moreover, a limited partner does not participate in the control of the business by virtue of being an employee or agent of the partnership. Id. Section 303(b)(l). Thus, for a RULPA limited partnership, even if a limited partner participates in the control of the business, he or she does not become liable for the obligations of the limited partnership unless he or she leads persons transacting business with the partnership to reasonably believe that he or she is a general partner. Based on this definition, it would appear to be a relatively rare circumstance where a limited partner would be treated under RULPA as liable for any partnership debts, and, even then, this falls short of being treated as a general partner.

In addition to serving a rather limited function, basing the self-employment tax result on what would have been possible under the applicable limited partnership law raises serious problems by tying the federal LLC NESE rules to the vagaries of state partnership * laws. First, it is not clear how a partnership standard like RULPA's would be applied to members of an LLC. Would the test be whether the non-managing member leads third parties to believe that he or she is a managing member? Is that a meaningful test where even managers have no liability for entity debts (and non-managers therefore have no reason to specify their status in dealing with third parties)? Second, the proposed test requires IRS agents, as well as taxpayers, to make hypothetical determinations of how different states' partnership laws might apply to persons who clearly are not governed by such laws. This is an unreasonable burden for the government and taxpayers alike. Third, under the proposed rule, the self-employment tax consequences to LLC members could change over time because of amendments to the state limited partnership law, or even court decisions under such law; this imposes further compliance burdens, and further illustrates the shortcomings of tying the tax treatment of one entity to state law rules affecting a different entity. Moreover, if, as we believe likely, LLCs replace limited partnerships over time as vehicles for conducting private business or investment activities, there will be correspondingly less law addressing the standards for limited partner qualification, making the determination required by the Proposed Regulation even more difficult and anachronistic. Finally, as LLCs replace limited partnerships, states' interests in restricting the availability of limited partner status may also wane. Accordingly, the reasons that today suggest the merits of

the Could-Have-Been-LP Rule may evaporate, and the NESE rules applied to LLC's may well begin to acquire state by-state peculiarities that should have no bearing on federal tax determinations.

The IRS has already dealt with the equivalence of LLC member-managers with general partners in the entity classification context and has not imposed an analogous rule in I that context. As noted above, in Rev. Proc. 95-10, the Service treats LLC member managers as equivalent to general partners for entity classification purposes. However, the Service makes no attempt to treat a non-managing member as a managing member in this context by reference to whether the non-managing member would have been treated as a limited partner or a general partner if the LLC had been organized as a limited partnership and the non-managing member had been a limited partner. We believe that the Service's approach in the entity classification area is correct, and we believe that in the NESE context the Could-Have-Been-LP Rule should be eliminated.

Technical Comments

A few technical points are worthy of mention. First, the Proposed Regulation refers only to LLCs, but limited liability partnerships ("LLPs") are also becoming more widely used and should be more clearly addressed. In New York State, members of limited liability partnerships are generally protected against liability for partnership debts (other than liabilities occasioned by the member's own negligence or wrongful acts), but their relationship is otherwise subject to New York's general partnership law. Based on the definitions in the Proposed Regulation, it would appear that a New York LLP would be considered an LLC, and either would be considered as having no managers (because none are specifically elected or designated), or as if each member had been vested with the requisite authority (see N.Y. Partnership Law § 20). We urge that specific consideration be given to LLPs in promulgating regulations under Section 1402(a)(13).

With respect to the definition of an LLC for purposes of the Proposed Regulation, it also should be noted that some states' LLC statutes "allow the limitation of the liability of all members for the organization's debts . . .", yet also permit members to elect to assume such liability, in which case the entity does not have limited liability under Treas. Reg. § 301.7701-2(d). The Proposed Regulation should explicitly address whether an entity that makes such an election is an LLC because it is "formed under" an LLC statute, or is not an LLC because some members have unlimited liability.