REPORT #810

TAX SECTION

New York State Bar Association

Tax Issues For Professional LLCs and LLPs

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Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Tax Issues For Professional LLCs and LLPs

Dear Secretary Samuels and Commissioner Richardson:

We are writing to suggest that guidance be provided on a number of issues relating to the operation of a professional service business as a limited liability company ("LLC") or a limited liability partnership ("LLP"). Recent state legislation authorizing these types of entities has created considerable interest among professionals in the operation of a professional firm as an LLC or LLP. However, there is uncertainty concerning a few key tax aspects of such an arrangement.

As discussed more fully below, a number of private letter rulings have been issued in some of these areas. However, it would be very useful if the conclusions were formalized and made available to a wider audience as quickly as possible. Such guidance would also greatly reduce the need to issue private letter rulings in the future on these issues.

The need for guidance with respect to professional LLCs is evident, since almost every state has adopted LLC legislation.

We also believe that guidance is needed with respect to LLPs. While fewer states (including New York) have adopted LLP legislation, we believe that in those states most professionals choosing to practice through an entity with limited liability will choose an LLP, particularly if they are converting from a general partnership.

We do not believe that the issues discussed below present real problems in the LLP context. However, these issues are relevant for a large number of professional firms which do not have any particular expertise in the relevant tax rules.

As a result, it would greatly facilitate the decision-making process as to conversions to professional LLCs and LLPs if the government's views on these issues were formalized and publicized. Any guidance provided should make clear any differences between the results for LLCs and LLPs, and any differences arising from differing statutory provisions of the LLC and LLP laws of different states.

The following discussion focuses on issues that are unique to professional practice LLCs and LLPs, and it assumes that capital is not a material income- producing factor in the operation of the professional business.

1. Summary

The recommended guidance set forth in this letter includes the following:

(1) the members of professional LLCs and LLPs are liable for self-employment taxes;

(2) the participation of the members in firm management and administrative activities ensures the continued availability of the cash method of accounting;

(3) retirement payments are still considered as deductible payments made to general partners; and

(4) for entity classification purposes an LLC or LLP would typically lack centralized management, an LLP would typically lack continuity of life, and a non-New York LLP would typically have unlimited liability.

2. Self-Employment Taxes

Code section 1402(a)(13) defines "net earnings from self-employment" as excluding "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments . . . for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services." The issue is whether a member of an LLC or LLP that is engaged in a professional practice can be a "limited partner" eligible for this exclusion. We believe the answer is no (disregarding for purposes of this letter the situation of retired partners).

LLCs. As a policy matter, we see no reason why members of professional firms that operate in LLC form should pay less self-employment tax than members of firms that operate as general partnerships. However, in the absence of specific Code amendments applying to LLCs, it is necessary to apply the existing statutory provisions. We note that the Service recently issued a private letter ruling that concluded, without much analysis, that members of a professional LLC were liable for self-employment taxes on their distributive shares of firm income. PLR 9432018.

We believe the analysis of this issue should proceed as follows. The Code does not define "limited partner" for purposes of section 1402(a)(13). Thus, there is no automatic answer to the application of the provision to a novel situation such as a member of an LLC, who is not literally a limited partner. In particular, a member's limited liability should not automatically make the member a limited partner for all purposes.[1] Rather, the availability of the statutory exception must be determined on the basis of the purpose of the exception. must be determined on the basis of the purpose of the exception.

The section 1402(a)(13) exclusion for limited partners was not adopted because of the fact that limited partners of a partnership are not

[1]Compare regulation section 1.469-5T(e)(3) (a partner with limited liability is always a limited partner for purposes of the passive loss rules). See also H.R. Rep. 6055, 97th Cong., 2dSess. 24 (1982), relating to the Subchapter S Revision Act of 1982; in describing necessary modifications to the partnership audit rules for Subchapter S corporations, it states that "a corporation has no person to correspond to a general partner, as such (since the corporate shareholders are not liable for the corporation's debts, as is a general partner)."

liable for debts of the partnership. Rather, it was adopted because limited partners of a partnership may receive only investment income from the partnership and need not perform any services for the partnership.[2] This rationale makes sense, since the existence or nonexistence of liability for partnership debts bears no apparent connection to the reasons for imposition of self-employment tax. As a result, the performance of services should be controlling, and the self-employment tax should apply to members of a professional LLC to the same extent that it applies today to a general partnership of professionals.

Guidance on this question would be very useful in order to avoid the risk that some professionals might take the position that they were "limited partners" not subject to the self-employment tax.

LLPs. The foregoing arguments apply equally well to members of professional LLPs, but there are even stronger arguments why such persons are properly subject to self-employment taxes. Under most states' LLP laws, members are generally protected only against liability for other members' malpractice, and otherwise continue to be fully liable as general partners for the debts of the LLP. In these cases, it should be clear that the members are not "limited partners." We note that New York's LLP statute is somewhat different, in that members are generally not liable for any debts of the LLP. However, the New York statute specifically provides that a registered LLP is a partnership without limited partners. N.Y. Partnership Law § 121-1500(a), (d). As a result, even if the term "limited partner" is interpreted under section 1402(a)(13) by reference to local law, members of a New York registered LLP would not qualify for the section 1402(a)(13) exemption.

3. Method of Accounting

Under section 448, an entity is precluded from using the cash method of accounting if it is a "tax shelter." A "tax shelter" includes an entity in which more than 35% of the losses are

[2]The provision was originally enacted as section 1402(a)(12) by P.L. 95-216, the Social Security Amendments of 1977, reprinted in 1978-1 Cum. Bull. 462. The limited partner provision is discussed in H.R. Rep. 95-702 Part 1, 95th Cong., 1st Sess. 40-41, 86 (1977), reprinted in 1978-1 Cum. Bull. 469, at 477, 483-4.

allocable to limited partners or limited entrepreneurs.§§ 448(a)(3), 461(i)(3), 1256(e)(3)(B), 464(e)(2).

A “limited entrepreneur” is a person with an interest other than as a limited partner, who does not actively participate in the management of the enterprise. Section 1256(e)(3)(B). Section 1256(e)(3)(C) provides that an interest is not treated as held by a limited partner or limited entrepreneur if(i) the individual “actively participates at all times during such period in the management of such entity,”(ii)the individual actively participated in the management of the entity for at least five years, or(iii)the Secretary determines (by regulations or otherwise) that such interest should be treated as held by an active participant and that the entity and the interest are not used for tax avoidance purposes. Regulation section 1.448-lT(b)(3) specifically makes this provision applicable to section 448 in determining whether an interest is held by a limited partner or limited entrepreneur. Proposed regulations under section 464, relating to persons actively engaged in the management or operation of a farming enterprise, are in the same vein:

> “For purposes of this section, the term “limited entrepreneur” means a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of such enterprise.” Proposed Regulation section 1.464-2(a)(3).

The issue is whether professional LLCs and LLPs should be treated as “tax shelters” precluded from using the cash method of accounting. For the reasons discussed below, we believe the answer is “no”.

The Service has issued quite a few private letter rulings concluding that such entities are permitted to use the cash method of accounting. These rulings have adopted two theories for this conclusion. In early rulings, there was a reliance on the fact that the firms had not and were not expected to generate losses, and hence would not allocate losses to any member. See, e.g., PLRs 8753032, 8911011. More recently, the rulings have referred to the nature of the members' participation in firm business and concluded that members with at least 65% of the loss shares are active participants in the management of the entity. See, e.g., PLRs 9321047, 9350013, 9407030 and 9412030.

However, in a number of rulings involving the conversion of a general partnership into an LLC or LLP, the Service has refused to explicitly address this issue, although it did rule that the new firm represents a continuation of the old firm under section 708(b)(1)(A), and that the prior accounting method must continue to be used in the absence of permission or direction from the Service to change accounting methods. See, e.g., PLRs 9226035, 9229016, 9250031 and 9423040.

For many firms, the decision to become an LLC or LLP is heavily influenced by the accounting method question. Guidance would clearly be useful, as would a general policy that does not require individual firms to obtain private letter rulings based on their own management arrangements.

LLCs. Applying the analysis above, the reference to “limited partners” in the definition of “tax shelter” seems clearly to have been based on the passive nature of a limited partner's investment, rather than on the limited liability of a limited partner for debts of the entity. Thus, professional members of LLCs should not be treated as “limited partners”.

Moreover, we believe that professional members of an LLC should in general not be treated as “limited entrepreneurs”. The Code has clearly carved out of the definition of tax shelter those businesses in which members are actively involved in management, and has given the Secretary specific authority to treat interests as held by active participants where tax avoidance is not present. We believe those conditions are satisfied with respect to a typical professional LLC.

For professional LLCs the key question is what “management” means. The classic law firm situation, in which member attorneys engage both in the practice of law and in various specific aspects of the administration of the firm, is a clear candidate for treatment as an enterprise in which the members actively participate in management. Private letter ruling 9407030 included a good practical description of the kinds of activities partners in law firms engage in:

> “The taxpayer represents that each member of the LLC will actively participate in the day-to-day responsibilities of recruiting, staffing, business development, selection of future members

> of the LLC, employee management, training and evaluation, and billing and collections. The members will conduct and manage their respective practices, which collectively will account for substantially all of the revenue of the LLC. The LLC Agreement vests management of the LLC in the members. However, the members will delegate management responsibilities to an Executive Committee comprised of the members. The Executive Committee is accountable to all the members; the Executive Committee is required to keep the members advised of all important committee actions; and the Executive Committee will serve at the will of the members. The taxpayer represents that the members as a whole are responsible for the management of the LLC's affairs notwithstanding the existence of the Executive Committee."

Based on these activities, the ruling concluded the firm was eligible to use the cash method.

Where members of a professional LLC actively engage in activities that relate to running the firm, it is consistent with section 448 to conclude that those members are not limited entrepreneurs. It should not be necessary for each member to actively participate in every management activity; nor should the presence of a firm "management" or "executive" committee mean that the rest of the members are not active participants in firm management where the individual members also have responsibilities and authority that involve them in the business or administration of the firm. Even where a firm has an Executive Committee with considerable authority over firm decisions, the members of the firm still will participate in day-to-day activities like those described in PLR 9407030, will actually work in the firm's practice, and will manage their own practices and the substantive aspects of providing services to firm customers. This, it would seem, should be sufficient to characterize the members as actively participating in firm management, and thus as members who are not limited entrepreneurs.[3]

[3] There might be situations where the analysis in this paragraph does not apply. For example, many accounting firms have "principals" who are partners for tax but not state law purposes and who do not participate in firm management. If these persons had more than a 35% share of the losses of the entity, the issues would be more difficult.

LLPs. Members of LLPs should not be treated as "limited partners" for purposes of section 446 not only for the foregoing reasons, but also for the reasons discussed under "Self-Employment Taxes—LLPs" above. Moreover, professional members of LLPs should not be treated as "limited entrepreneurs" for the same reasons that professional members of LLCs should not be so treated. As a result, professional LLPs likewise should be eligible for the cash method of accounting.

4. Section 736

Prior to 1993, section 736(b)(2) provided that amounts paid to a retiring partner for unrealized receivables and goodwill were not treated as redemption payments under sections 731 and 734. This permitted a partnership a current deduction for amounts paid to retirees for their interest in unrealized receivables and goodwill.

In 1993, section 736(b)(3) was added to limit this favorable current deduction treatment to cases in which (i) capital is not a material income-producing factor for the partnership, and (ii) the retiree "was a general partner in the partnership." The legislative history of section 736(b)(3) states that law and other professional firms are not partnerships for which capital is a material income-producing factor.[4] The general partnership law firm can therefore continue to make payments to retiree partners without concern that such payments might be nondeductible.

The issue is whether retiring members of a professional LLC or LLP should be treated as general partners for purposes of this provision. We believe the answer is "yes," even though such members are not generally liable for debts of the entity.

[4]H.R. Rep. 103-111, 103d Cong., 1st Sess. 782-3 (1993); H.R. Conf. Rep. 103-213, 103d Cong., 1st Sess. 697-8 (1993).

LLCs. Applying the analysis described above, we believe the term “general partner” in section 736(b)(3) should be interpreted on the basis of the activities of the member rather than on the basis of whether the member is liable for debts of the entity. This conclusion is based on the fact that the purpose of the provision is to distinguish compensatory from no compensatory payments, and liability for debts of the entity is not relevant for this purpose. We also note the clear tenor of the legislative history that professional firms are not the kinds of businesses at which the amendment was aimed. Finally, there seems to be no principled basis for requiring some professional firms to capitalize retirement payments while others deduct them, based solely on whether the recipient retiree bore personal liability for firm debts.

LLPs. The arguments for treating members of an LLC as “general partners” for purposes of section 736(b)(3) apply equally to members of an LLP. In any event, the reasons described under “Self-Employment Taxes--LLPs” should be determinative in concluding that LLP members are general partners for this purpose.

5. Entity Classification

a. Centralized management.

LLCs. Under the Service's ruling position, centralized management will exist in a professional LLC unless the articles of the LLC provide that the LLC is managed by all of its members acting in their capacities as members. A professional LLC will generally provide for this type of member management in its operating agreement, both to avoid centralized management and for business reasons. However, an issue of significance to a professional LLC is whether the delegation of powers to a “management” or “executive” committee might nevertheless create centralized management. For the reasons discussed below, we do not believe that the presence of such committees should generally cause an LLC to have centralized management. A ruling on this issue would be very helpful.

In large firms in particular, it is common for some group of members to be elected or designated to manage certain aspects of the business. Often these committees propose or establish compensation levels for the firm. In some

cases, it is even possible that decisions of such significance as the admission of new partners are made by the committee, although this is not common.

However, as discussed above, even in entities with a strong management committee, it is common for members to devote significant time and energy to performing certain important firm functions individually, such as associate recruitment, client development, rendering opinions, billing, etc. See, e.g., PLR 9407030. Most importantly, members of professional firms actively manage the business of servicing the firm's clients, which should be considered the most important aspect of firm management. Members would also typically be required to approve major management decisions. We therefore believe that the presence of the classic law firm management committee does not result in centralized management, where the operating agreement provides for member management and most of the members of the firm remain responsible for some administrative matters and for managing their own practice and clients.

LLPs. An LLP is always managed by its members, with each having the power to bind the entity in the same manner as a general partner of a partnership. We believe this constitutes the mutual agency contemplated by Regulation section 301.7701-(2)(c)(4), such that an LLP should always be considered to lack centralized management. A partnership management committee should no more create centralized management in an LLP than it does today in a general partnership.

We recognize that under the New York LLP statute, each member's authority to bind the LLP does not have the effect of putting at the risk of the business the non-LLP assets of other LLP members. The New York LLP therefore differs slightly from a general partnership in that the mutual agency of general partners does extend beyond the business of the partnership by putting personal assets of the partners at risk. We believe, however, that the relevant question should be the members' authority over the entity and its business, not the members' authority over assets unrelated to the entity. Thus, we believe that the difference between general partnerships and New York LLPs is of insufficient import to cause there to be centralized management in a New York LLP.

b. Continuity of Life.

LLPs. Under New York's LLP statute, an LLP continues to be governed by the state general partnership law. In particular, while the limitations on partner liability are achieved by filing the required LLP registration, the relationships of the members are defined by the general partnership law. Thus, a registered LLP dissolves on the death of a member in exactly the same manner as does a general partnership. It is therefore clear that an LLP with individual members automatically lacks continuity of life, as does a general partnership. A ruling to confirm this conclusion as to the New York statute (and any other state statute with similar provisions) would be helpful.

c. Unlimited liability

LLPs. In most states (not including New York), a partner of an LLP has unlimited liability for all debts of the LLP except for liability for malpractice by other members. We believe this specified exclusion from liability should not prevent the members from being considered to have unlimited liability. A ruling to this effect would be helpful.

6. Conclusion

Resolution of the foregoing issues along the lines discussed herein would greatly facilitate conversion of professional partnerships to LLC or LLP status by providing practical, understandable answers to the questions many professionals are now asking.

Please let me know if you have any questions regarding any of the foregoing or if we can be of further help in this area.

Very truly yours,

Michael L. Schler
Chair, Tax Section