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Recent SE and Payroll Tax Developments in the LLC Arena

DELAWARE TAX INSTITUTE

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SE Tax Fundamentals

- IRC 1401 – “self employment income” is taxed at 15.3%
 - 12.4% to Old Age, Survivors, Disability
 - 2.9% Medicare Tax
- Under IRC Section 1402, “self-employment income” is generally defined as the gross income derived by an individual from any trade or business carried on by the individual, less deductions allocated to the business.
- Explicitly included within the definition of self-employment income is a partner’s distributive share of income or loss from any trade or business carried on by a partnership.
- IRC 1402(a)(13) provides that the distributive share of partnership income of a limited partner (other than guaranteed payments) is NOT included in self-employment income.

SE Tax Fundamentals (Continued)

- **Question** – Is an LLC member a “limited partner” within the meaning of IRC 1402(a)(13)?
- In 1997, the IRS issued proposed regulations that would govern whether the distributive share of partnership income of LLC members was included in self-employment income. It basically provided that an LLC member would be treated as a limited partner — **and thus the distributive share would NOT be self-employment income**– unless the LLC member either:
 - 1) had personal liability for the debts of the LLC under state law;
 - 2) has authority under state law to contract on behalf of the LLC; or
 - 3) participated in the trade or business of the LLC for more than 500 hours during the year.

SE Tax Fundamentals (Continued)

- Proposed Regulations NEVER finalized
- Cases on the Issue
 - *Renkmeyer* – law firm partners NOT limited partners
 - *Riether* – husband/wife providing radiological imaging services; husband/wife were members of the LLC and provided the services; paid W2 ways (despite Rev. Rul. 69-184); husband/wife argued they were not self-employed as employed by partnership and thereby excluded all distributive income from SE Tax. Court held stated that because the members managed the LLC and provided all of its services, the LLC was not a “limited partnership” and the members were not “limited partners.” As a result, all of their LLC income — not just the income from the W-2 — was subject to SE tax.
- CCA 201436049

Recent Development

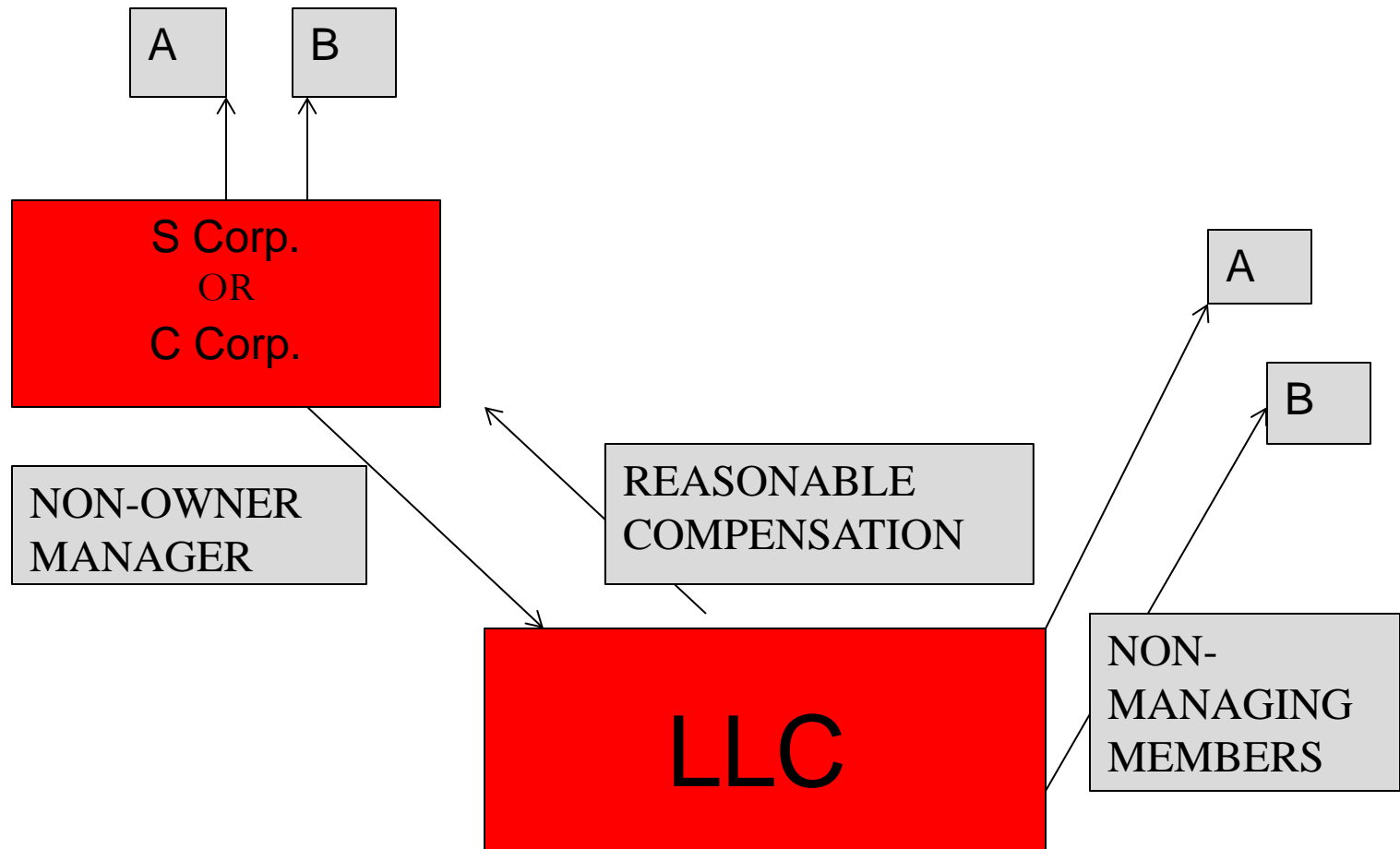
- CCA 201640014
- Taxpayer owned several restaurant franchises through an LLC. Taxpayer owned majority with wife and wife's irrevocable trusts owning minority interests. Wife and wife's trust's status as limited partners under IRC 1402(a)(13) were not questioned. Taxpayer was manager and CEO and handled day to day operations. Taxpayer also made large capital investments. Taxpayer was paid a guaranteed payment representing a "reasonable" salary.

CCA 201640014 - HOLDING

- Taxpayer is not a limited partner for purposes of § 1402(a)(13). As discussed above, the Renkemeyer Court reviewed the legislative history of § 1402(a)(13) and concluded that § 1402(a)(13) was intended to apply to those who “merely invested” rather than those who “actively participated” and “performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons).” The Renkemeyer Court explained that “the interest of a limited partner in a limited partnership is generally akin to that of a passive investor.” Here, Taxpayer has sole authority over Partnership, and is the majority owner, Operating Manager, President, and Chief Executive Officer with ultimate authority over every employee and each aspect of the business. Even though Partnership has many employees, including several executive- level employees, Taxpayer is the only partner of Partnership involved with the business and is not a mere investor, but rather actively participates in the partnership’s operations and performs extensive executive and operational management services for Partnership in his capacity as a partner (i.e., acting in the manner of a self-employed person). Therefore, the income Taxpayer earns through Partnership is not income of a mere passive investor that Congress sought to exclude from self-employment tax when it enacted the predecessor to § 1402(a)(13).



LLC SE Tax Planning Structure

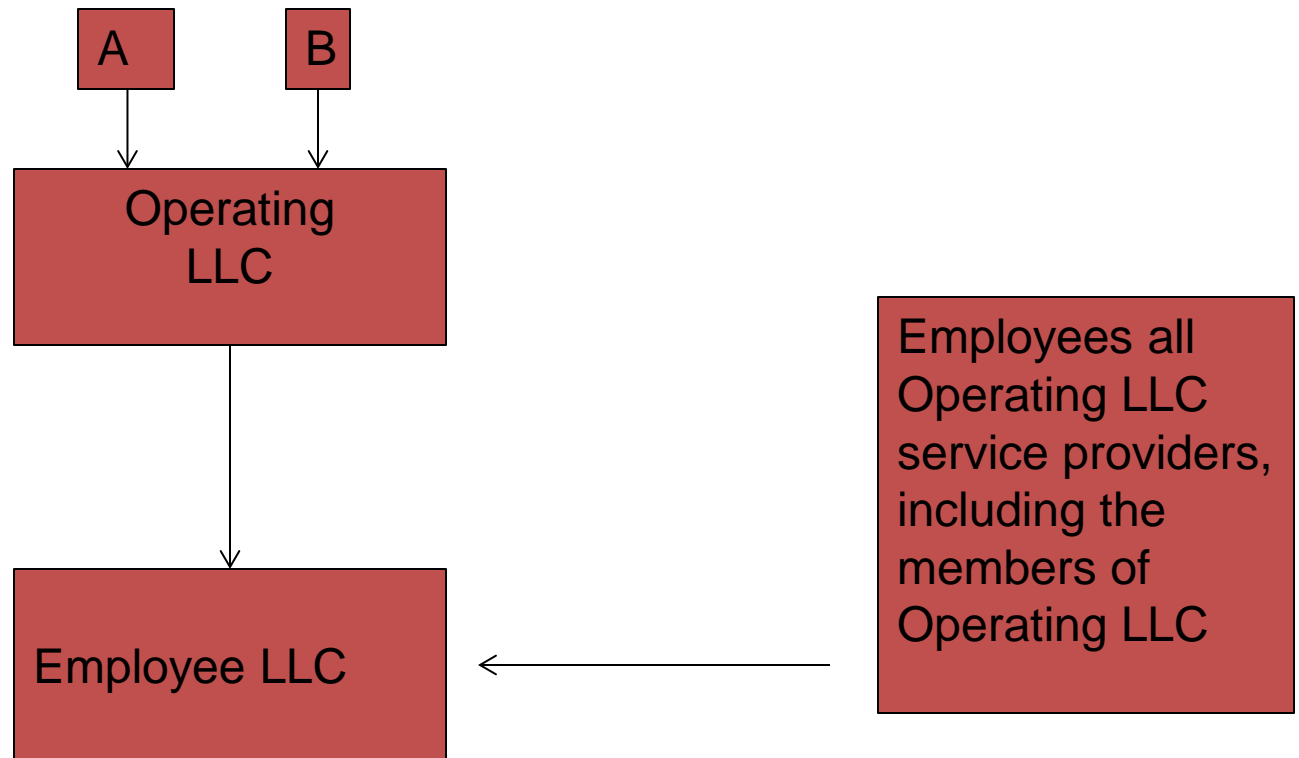


Disregarded Entity Employer Approach

- Partners as Employees
 - There are some taxpayers who continue to pay wages to partners notwithstanding the IRS's position in Rev. Rul. 69-184 that partners in a partnership cannot be employees.
 - This causes concern for many tax professionals – however, some have looked the other way finding comfort in the fact that it is difficult to ascertain what penalties could be imposed since the IRS is receiving its payroll taxes at a potentially earlier time.

Disregarded Entity Employer Approach

- Some professionals concerned with the payment of W2 wages have used the following structure:



Disregarded Entity Employer Approach

- Some professionals had been of the view that this approach is valid because the single member LLC is considered a separate entity for payroll tax purposes (i.e., a corporation – see Reg. § 301.7701-2(c)(2)(iv)(B)), notwithstanding that the entity is disregarded for other purposes.
- On May 4, 2016, Treasury issued temporary regulations providing that this is not a valid approach for the treatment of compensation to members of the parent LLC from a wholly owned LLC subsidiary. Temp. Reg. § 301.7701-2(c)(2)(iv)(C)(2). Instead, the temporary regulations provide that the partners of the parent LLC are subject to the same SE tax rules as partners in a partnership that does not “employ” the parent LLC members in a disregarded entity.

Disregarded Entity Employer Approach

- Notable Facts Regarding Temporary Regulations
 - Temporary Regulations provided a delayed effective date
 - Generally, August 1, 2016
 - Do Not Address Tiered Partnership (Regarded Entity) Structures although IRS is aware
 - May ABA Tax Section Meeting, IRS Associate Chief Counsel :
 - Questioned Use of Tiered Structure
 - Indicated Open Question as to prior open years where taxpayer used the disregarded entity approach for payroll tax reporting.

Questions?

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