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Employment Taxes in the Land of LLCs and Partnerships

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Employment tax for members of LLCs taxed as partnerships and partners of partnerships (I refer to them interchangeably as partners in this article) is often confusing, counterintuitive and annoying. Which partners/members must pay self-employment taxes, and on what portion of their income must they pay such tax. This brief article attempts to reduce the pain a bit.

Employment Taxes in the Corporate World

The tax law imposes FICA (Federal Insurance Contributions Act) taxes on employers and employees. The tax on an employee is 6.2 percent of her "wages", up to a limit known as the contribution and benefit base. A Medicare tax of 1.45% is also imposed on the employee. The employer must withhold and deduct these so-called "employment" taxes from the wages paid to the employee. Wages generally means all remuneration paid for employment.

The employer must also pay taxes equal to 6.2 percent of an employee's wages (up to the contribution and benefit base), and a Medicare tax of 1.45 percent of an employee's wages.

Limited Liability Companies and Partnerships

That was easy. Now it gets more complicated. Partners and LLC members who work for their companies are not employees and payments to them for their services are not subject to employment taxes. But some or all of those payments may be subject to self-employment tax.

Where a taxpayer receives self-employment income (as opposed to wages), he is responsible for paying self-employment taxes of 12.40 percent of his "self-employment income" up to the contribution and benefit base. He is also subject to the Medicare tax of 2.9 percent of his self-employment income (but not limited to the contribution and benefit base). Together, these taxes are referred to as "SE taxes."

Partners and Members are not considered employees of the partnership/LLC, and subject to several important exceptions, their shares of partnership income as well as any so-called "guaranteed payments" (i.e., a salary) are specifically deemed to be self-employment income subject to the SE tax. A partnership cannot withhold income taxes from a partner's distributive share of income or from guaranteed payments. Instead, a partner must file estimated income tax returns.

Self-employment income means the "net earnings from self-employment." The net earnings from self-employment means "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions ... attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss … from any trade or business carried on by a partnership of which he is a member; [subject to certain exceptions]". In general, limited partners are not subject to the SE tax for their distributive shares of income, except to the extent they receive guaranteed payment for services rendered. In addition, certain types of income are not subject to the SE tax, such as rental income, dividends, the sale or exchange of a capital asset, and various other items of income.

A question often arises as to whether a member of a limited liability company is to be considered a limited partner for purposes of the SE tax. The IRS issued proposed regulations which provide that a person will be considered a limited partner (and therefore not subject to SE taxes), unless the individual – (1) has personal liability for partnership debts; (2) has authority to contract on behalf of the partnership; or (3) participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year. In many cases, an LLC managing member provides more than 500 hours of services to the LLC and usually has the authority to contract on behalf of the partnership. These factors would normally cause him to not be considered a limited partner.

However, the proposed regulations provide that a person who works for an LLC for more than 500 hours and owns more than one class of partnership or membership interests will be treated as a limited partner with respect to a specific class of partnership interest if,

immediately after acquiring that class of interest, (i) the limited partners as a class own a substantial, continuing interest in that class of partnership interest, and (ii) the individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of that specific class held by the limited partners.

Thus, for example, assume that Bill and Sue form an LLC. They each contribute $50 for 50 LLC interests each. Bill will provide management services, and Sue is a passive investor (having no managerial control). The LLC issues two classes of Units: 1 Class A Unit (to be owned by the person providing services) and 99 Class B Units (to be owned by the investors). Bill will own 1 Class A Unit (the managerial unit), and 49 Class B Units (the investor units). Sue will own 50 Class B Units. With respect to the Class B Units owned by Bill, he should be treated as a limited partner, because 99% of the LLC interests are owned by "limited partners," and the Class B Units owned by Bill are identical to the Class B Units owned by Sue. As a result, only Bill's share of income attributable to the Class A Unit should constitute self-employment income, but not the income attributable to the Class B Units. Bill will have to pay SE on his guaranteed payments also.

Of course, proposed regulations are not law, and cannot be relied upon to achieve this result. However, this presents a viewpoint of the IRS.

S Corporation Comparison

Some taxpayers seek to reduce the amount of SE taxes by conducting business in the form of an S corporation instead of a partnership. The reason is that distributions (as opposed to wages) from an S corporation are not considered self-employment income. Ideally, an S corporation shareholder would only take distributions, instead of a salary or other compensation, since distributions are not subject to SE taxes. However, the IRS can, and has, re-characterized some or all of these distributions to a shareholder as compensation income, subject to wage withholding and the Medicare tax.

In many situations, there are significant tax advantages of operating a business in the form of a partnership or LLC. Among them are: (a) partners have great flexibility in allocating profits and losses among themselves, whereas in an S corporation, all income and losses must be allocated pro rata in proportion to stock ownership; (b) a partner's adjusted basis for his partnership interest is increased by his share of partnership debt (thereby permitting the partner to recognize less gain on the sale of his interest or allowing him to deduct more losses), but an S corporation shareholder cannot do so; (c) there are no limitations on who can be a partner in a partnership, but there are substantial restrictions under the tax law on who can be an S corporation shareholder; and (d) a partnership may make certain special basis adjustments to its property on the sale of a partnership interest, the death of a partner, or on certain partnership distributions, but an S corporation cannot.

The lesson here is to be careful if you desire to form an S corporation just to save SE taxes; your compensation must be reasonable and if it is too low, the IRS can re-characterize dividends as compensation. And you may miss the many tax advantages available to companies taxed as partnerships.

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