LLCs and Self-Employment Tax – Part One

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
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Overview

Farmers and ranchers often desire to avoid the payment of self-employment tax. Indeed, avoidance of self-employment tax sometimes seems to be a prerequisite for being engaged in a farming or ranching activity. One way to structure the business to minimize self-employment tax might be as a limited liability company (LLC). For an LLC member that truly has a limited partnership interest, self-employment tax savings can be achieved. But truly being a limited partner is the key. The definition of a "limited partner" as an LLC member for self-employment tax purposes has been unclear and confusing for some time.

In today's Part One of a two-part series, I take a look at how the courts (and IRS) view a limited partner in the context of an LLC. The analysis derives from the passive loss rules and from a proposed regulation issued in the late 1990s.

LLCs and self-employment tax – Part One of a two-part series – it's the topic of today's post.

Background

In its 2017-2018 Priority Guidance Plan, the IRS stated that it planned to finalize regulations under I.R.C. §469(h)(2) – the passive loss rules. That provision creates a per se rule of non-material participation for limited partner interests in a limited partnership unless the Treasury specifies differently in regulations. Those regulations were initially issued in temporary form and became proposed regulations in 2012. *2012-9, IRB 434*

Passive Loss Rules

The passive loss rules of I.R.C. §469 can have a substantial impact on farmers and ranchers as well as investors in farm and ranch land. The effect of the rules is that deductions from passive trade or business activities, to the extent the deductions exceed income from all passive activities, may not be deducted against other income.

The proper characterization of the loss depends on whether the taxpayer is materially participating in the business. I.R.C. §469(h). But, I.R.C. §469(h)(2) creates a per-se rule of non-material participation for limited partner interests in a limited partnership *unless the Treasury specifies differently in regulations*. The statute was written before practically all state LLC statutes were enacted and before the advent of LLPs, and the Treasury has never issued regulations to detail how the statue is to apply to these new types of business forms.

Material participation tests. The key question presented in the cases was whether the taxpayer satisfied the material participation test. As mentioned above, a passive activity is a trade or business in which the taxpayer does *not* materially participate. Material participation is defined as "regular, continuous, and substantial involvement in the business operation." I.R.C. §469(h)(1). The regulations provide seven tests for material participation in an activity. Temp. Treas. Reg. §1.469-5T(a)(1)-(7).

The tests are exclusive and provide that an individual generally will be treated as materially participating in an activity during a year if:

- The individual participates more than 500 hours during the tax year;
- The individual's participation in the activity for the tax year constitutes substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the tax year;
- The individual participates in the activity for more than 100 hours during the tax year, and the individual's participation in the activity for the tax year is not less than the participation in the activity of anyone else (including non-owners) for the tax year;
- The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities during the tax year exceeds 500 hours;
- The individual materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the tax year at issue;
- The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years preceding the tax year at issue; or
- Based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year

As noted, if the taxpayer is a limited partner of a limited partnership, the taxpayer is presumed to *not* materially participate in the partnership's activity, "except as provided in the regulations." *I.R.C. §469(h)(2).* The regulations provide an exception to the general presumption of non-material participation of *limited partners in a limited partnership* if the taxpayer meets any of one of three specific material participation tests that are included in the seven-part test for material participation under Treas. Reg. 1.469-5T(a)(1)-(7). Those three tests are:

- The 500-hour test;
- The five out of 10-year test; and
- The test involving material participation in a personal service activity for any three years preceding the tax year at issue.

Thus, the standard of "material participation" for a *limited partner* is different than that for a general partner, and the question presented in the cases was whether the more rigorous standard for material participation for *limited partners in a limited partnership* under I.R.C. §469(h)(2) applied to the taxpayers (who held membership interests in LLCs and LLPs) with the result that their interests were per-se presumptively passive.

Relevant Court Opinions

Courts have concluded, in certain instances, that the holder of a limited liability company (LLC) interest is not treated as holding an interest in a limited partnership as a limited partner for purposes of applying the I.R.C. §469 material participation tests.

For example, in *Garnett v. Comr. 132 T.C. 368 (2009),* the taxpayers were a married couple that owned interests in various LLCs and partnerships organized under Iowa law, as well as certain tenancy-in-common

interests that were all engaged in agricultural production activities. They held direct ownership interests in one LLP and LLC and indirect interests in several other LLPs and LLCs. Their ownership interests were denoted as "limited partners" in the LLP and "limited liability company members" in the LLC – which did have a designated manager. The interests that they held in the two tenancies-in-common were also treated similarly. For tax years 2000-2002, the taxpayers ran up large losses and treated them as ordinary losses.

The IRS claimed that an LLC member is *always* treated as a limited partner because of limited liability under state law and because the Code specifies that a limited partnership interest never counts as an interest with respect to which the taxpayer materially participates. I.R.C. §469(h)(2). Thus, the IRS characterized the losses as passive, basing their position on the regulation which, for purposes of I.R.C. §469, treats a partnership interest as a limited partnership interest if "the liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount." Temp. Treas. Reg. §1.469-5T(e)(3)(i)(B). On the other hand, the taxpayers argued that the Code and regulations did not apply to them because none of the entities that they had interests in were limited partnerships and because, in any event, they were general partners rather than limited partners. The taxpayers also pointed out that the Federal District Court for Oregon had previously ruled that, under the Oregon LLC Act, I.R.C. §469(h)(2) did not apply to LLC members. Gregg v. United States, 186 F. Supp. 2d 1123 (D. Ore. 2000).

The Tax Court first noted that I.R.C. §469(h)(2) was enacted at a time when LLCs and LLPs were either new or nonexistent business entities and, as such, did not refer to those entities. The court also pointed out that the regulations did not refer explicitly to LLPs or LLCs. Accordingly, the court rejected the IRS argument that a limitation on liability *automatically* qualifies an interest as a limited partnership interest under I.R.C. §469(h)(2). On the contrary, the court held that the correct analysis involved a determination of whether an interest in a limited partnership (or LLC) is, based on the particular facts, actually a limited partnership interest. That makes a state's LLC statute particularly important. Does it grant LLC and LLP members power and authority beyond those that limited partners have traditionally been allowed.? The IRS conceded that the statute at issue in the case did just that. Other distinguishing features were also present. The court noted that limited partnerships have two classes of partners, one of which runs the business (general partners) and the other one which typically involves passive investors (limited partners). The limited partners enjoy limited liability, but that protection can be lost by participating in the business. By comparison, an LLP is essentially a general partnership in which the general partners have limited liability even if they participate in management. Likewise, the court noted that LLC members can participate in management and retain limited liability.

Note: The court made a key point that it was not invalidating the temporary regulations but was simply declining to write a regulation for the Treasury that applied to interests in LLCs and LLPs. Importantly, the court refused to give deference to the Treasury's litigating position in absence of such a regulation.

In *Thompson v. United States*, 87 Fed. Cl. 728 (2009), the taxpayer held a 99 percent interest in an LLC that was formed under the Texas LLC statute. He held the other one percent interest indirectly through an S corporation. The LLC's articles of organization designated the taxpayer as the manager. The LLC did not make an election to be taxed as a corporation and, thus, defaulted to partnership tax status. The LLC, which provided charter air services, incurred losses in 2002 and 2003 of $1,225,869 and $939,878 respectively which flowed through to the taxpayer. The IRS disallowed most of the losses on the basis that the taxpayer did not meet the more rigorous test for material participation that applied to limited partners in limited partnerships. The taxpayer paid the additional tax of $863,124 and filed a refund claim for the same amount. The IRS denied the refund claim and the taxpayer sued for the refund, plus interest. Both the taxpayer and the IRS moved for summary judgment.

The IRS stood by its position that the more rigorous material participation test applied because the taxpayer enjoyed limited liability by owning the interests in the LLC just like he would if he held limited partnership interests. Thus, according to the IRS, the taxpayer's interest was identical to a limited partnership interest and the regulation applied triggering the passive loss rules.

The court disagreed with the IRS. While both parties agreed that the statute and regulations trigger application of the passive loss rules to limited partnership interests, the taxpayer pointed out that he didn't hold an interest in a limited partnership. The court noted that the language of *Treas. Reg. § 1.469-5T(e)(3)* explicitly required that the taxpayer hold an interest in an entity that is a partnership under state law, and that the Treasury had never developed a regulation to apply to LLCs. It was clear that the taxpayer's entity was organized under Texas law as an LLC. In addition, the court pointed out that the taxpayer was a manager of the LLC, and IRS had even conceded at trial that the taxpayer would be deemed to be a general partner if the LLC were a general partnership. The court noted that the position of the IRS that an LLC taxed as a partnership triggers application of the Treas. Reg. §1.469-5T(e)(3)(ii) was "entirely self-serving and inconsistent." The court also stated that it was irrelevant whether the taxpayer was a manager of the LLC or not – by virtue of the LLC statute, the taxpayer could participate in the business and not lose the feature of limited liability.

Hegarty v. Comr., *T.C. Sum. Op. 2009-153*, is a Tax Court summary opinion where the Tax Court reiterated its position that the reliance by IRS on I.R.C. § 469(h)(2) to treat members of LLCs as automatically limited partners for passive loss purposes is misplaced. Instead, the general tests for material participation apply and the petitioners in the case (a married couple) were determined to have materially participated in their charter fishing activity for the tax year at issue. They participated more than 100 hours and their participation was not less than the participation of any other individual during the tax year.

In *Newell v. Comr., T.C. Memo. 2010-23,* the taxpayer's primary business activity was managing various real estate investments. He spent more than one-half of his time and more than 750 hours annually in real property trade or business activities. During the years at issue, the taxpayer was the sole owner of an S corporation that manufactured and installed carpentry items, and his participation is that business qualified as a significant participation activity for purposes of the passive loss rules. He also owned 33 percent of the member interests in a California-law LLC engaged in the business of owning and operating a golf course, restaurant and country club. The LLC was treated taxwise as a partnership. It was undisputed that the taxpayer was the managing member of the LLC. For tax years 2001-2003, IRS claimed that the losses the taxpayer incurred from both the S corporation and the LLC were passive losses that were not currently deductible. While the parties agreed that the taxpayer's participation in both the S corporation and the LLC satisfied the significant participation activity test under the passive loss rules, IRS again asserted its position that I.R.C. §469(h)(2) required that the taxpayer's interest in the LLC be treated as a passive limited partnership interest, even though IRS conceded that the taxpayer held the managing member interest in the LLC.

The Tax Court rejected the IRS' argument, noting again that the general partner exception of Treas. Reg. §1.469-5T(e)(3)(ii) was not confined to the situation where a limited partner also holds a general partnership interest. Under the exception, an individual who is a general partner is not restricted from claiming that the individual materially participated in the partnership. Here, it was compelling that the taxpayer held the managing member interest in the LLC. As such, the taxpayer's losses were properly deducted.

In *Chambers v. Comr., T.C. Sum. Op. 2012-91,* the taxpayer owned rental property with his spouse that produced a loss. The taxpayer was also a managing member of an LLC that owned rental properties. The LLC also owned rental property, and produced losses with one-third of the losses allocated to the taxpayer. The taxpayer was also employed by the U.S. Navy. He deducted his rental losses in full on the basis that he was a real estate professional. In order to satisfy the "more than 50 percent test," he combined

his hours spent on his personally-owned rental activity with his management activity for the LLC. The IRS invoked I.R.C. §469(h) to disallow the taxpayer's LLC managerial hours, but the court disagreed. The court held that the taxpayer's LLC interest was not defacto passive. Thus, his hours spent in LLC managerial activities counted toward his total "real estate" hours. However, he still failed to meet more than 50 percent test. In addition, the court noted that the fallback test of active participation allowing $25,000 of rental real estate losses was not available because the taxpayer's AGI exceeded $150,000 for the year in issue.

Conclusion

Whether a member of an LLC is a limited partner or not boils down to the particular provisions of a state's LLC statute and whether there are sufficient factors under the state statute that distinguish an LLC from a limited partnership. That will be the case until IRS issues regulations dealing specifically with LLCs and similar entities.

As noted above, in late 2011, the Treasury Department proposed regulations defining "limited partner" for purposes of the passive loss rules. *Notice of Proposed Rulemaking REG-109369-10 (Nov. 28, 2011).* The proposed definition would make it easier for LLC members and some limited partners to satisfy the material participation requirements for passive loss purposes, consistent with the court opinions that IRS has recently lost on the issue. Specifically, the proposed regulations require that two conditions have to be satisfied for an individual to be classified as a limited partner under I.R.C. §469(h)(2): (1) the entity must be classified as a partnership for federal income tax purposes; and (2) the holder of the interest must not have management rights at any time during the entity's tax year under local law and the entity's governing agreement. Thus, LLC members of member-managed LLCs would be able to use all seven of the material participation tests, as would limited partners that have at least some rights to participate in managerial control or management of a partnership.

In Part Two, I will dig deeper into the self-employment tax issue.

K-State Agricultural Economics | 342 Waters Hall, Manhattan, KS 66506-4011 | 785.532.1504
www.ageconomics.k-state.edu
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