LLCs/LPs and S.E. Tax – Will Steve Cohen Now Settle?

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

As I have previously written on this blog, a big question in self-employment tax planning is whether an LLC member is a limited partner. In those prior articles, it was noted that the IRS/Treasury hadn't yet finalized a regulation that was initially proposed in 1997 to address the issue. For businesses other than those providing professional services, characterization of an LLC member's interest is determinative of whether the member has self-employment tax liability on amounts distributed to the member (other than guaranteed payments). That means that proper structuring of the entity matters as does the drafting of the LLC operating agreement and the conduct of the members.

Now, the U.S. Tax Court has issued a fully reported opinion confirming that state law classifications of a partner's interest is not conclusive on the self-employment tax issue. That is a key point because Steve Cohen, owner of the New York Mets, has filed a case with the Tax Court challenging the assessment of self-employment tax on about $350 million in distributions (other than guaranteed payments to limited partners in his investment (hedge fund) firm. Is the Tax Court's recent opinion a warning to Mr. Cohen that he should look to settle his case? Perhaps.

Self-employment tax implications of LLCs – when is a member really a limited partner? That's the topic of today's post.

Background - LLCs and Self-Employment Tax

Net earnings from self-employment includes the distributive share of income or loss from a trade or business carried on by a partnership. *I.R.C. §1402(a).* Thus, the default rule is that all partnership income is included, unless it is specifically excluded. Whether LLC members can avoid self-employment tax on their income from the entity depends on their member characterization. Are they general partners or limited partners? Under I.R.C. §1402(a)(13), a limited partner does not have self-employment income except for any guaranteed payments paid for services rendered to the LLC. So, what is a limited partner? The test of whether an interest in an entity treated as a partnership for tax purposes is treated as a limited interest or a general interest, for the purpose of applying the self-employment tax is stated at Prop. Reg. §1.1402(a)-2(h), issued in 1997.

Note: Immediately after the Proposed Regulation was issued, the Congress passed a statute prohibiting the IRS from finalizing the Regulation within one year. Nothing further has been forthcoming. Although still in Proposed Regulation form, this regulation remains the best available authority.

The Proposed Regulation establishes a three-part general rule, with two exceptions, that may permit limited partner treatment under certain conditions. A third exception to limited partner treatment applies in the context of professional service businesses (e.g., law, accounting, health, engineering, etc.). Under the general rule, a member is *not* treated as a limited partner if: (1) the member has personal liability for the debts or claims against the LLC by reason of being a member; (2) the member has authority under the state's LLC statute to enter into contracts on behalf of the LLC; or (3) the member participated in the LLC's trade or business for more than 500 hours during the LLC's tax year. *Prop. Treas. Reg. §1.1402(a)-2(h)(2).*

An exception applies only if the interest-holder owns a *single class of interest* (regardless of whether there are multiple classes outstanding) and failure of the 500-hour test is the sole reason for treatment of the interest as a general interest. In addition, the interest held must meet certain threshold requirements:

- There must be at least one member holding the same class of interest who meets all three of the requirements under the general rule, without application of any exceptions;
- The share of that class of interest held by those members must be "substantial" (with respect to the class of interest at issue and not with respect to the entity as a whole), based on the facts and circumstances (a safe harbor of 20 percent, in aggregate, is provided at Treas. Reg. §1.1402(a)-2(h)(6)(v)); and
- The interests held by those members must be "continuing" (an undefined term).

Another exception to the general rule applies *only if the member owns at least two classes of interests* and the same threshold requirements are satisfied. This exception may permit a member to treat the distributive share attributable to at least one class as a limited interest if the three requirements of the general rule are met with respect to *any class* that the member holds. In that case the distributive share attributable to that interest is not subject to self-employment tax. But, the distributive share attributable to any interest held by a member that does not meet the three requirements of the general rule is subject to self-employment tax. This all means that a portion of a member's total distributive share may be subject to self-employment tax, and some may not be.

Note: Under the general rule, it is likely that the entire distributive share of all members of a member-managed LLC will be subject to self-employment tax because state law likely gives all members the authority to contract. Likewise, LLP statutes likely give management rights which means that the second requirement of the general rule cannot be satisfied. As a result, neither exception to the general rule can be met because both exceptions require at least one member to satisfy all three requirements of the general rule.

The *Castigliola* case. In *Castigliola, et al. v. Comr, T.C. Memo. 2017-62*, a group of lawyers structured their law practice as member-managed Professional LLC (PLLC). On the advice of a CPA, they tied each of their guaranteed payments to what reasonable compensation would be for a comparable attorney in the locale with similar experience. They paid self-employment tax on those amounts. However, the Schedule K-1 showed allocable income exceeding the member's guaranteed payment. Self-

employment tax was not paid on the excess amounts. The IRS disagreed with that characterization, asserting self-employment tax on all amounts allocated.

The Tax Court (Judge Paris) agreed with the IRS. Based on the Uniform Limited Partnership Act of 1916, the Revised Limited Partnership Act of 1976 and Mississippi law (the state in which the PLLC operated), the court determined that a limited partner is defined by limited liability and the inability to control the business. The members couldn't satisfy the second test. Because of the member-managed structure, each member had management power of the PLLC business. In addition, because there was no written operating agreement, the court had no other evidence of a limitation on a member's management authority. In addition, the evidence showed that the members actually did participate in management by determining their respective distributive shares, borrowing money, making employment-related decisions, supervising non-partner attorneys of the firm and signing checks. The court also noted that to be a limited partnership, there must be at least one general partner and a limited partner, but the facts revealed that all members conducted themselves as general partners with identical rights and responsibilities. In addition, before becoming a PLLC, the law firm was a general partnership. After the change to the PLLC status, their management structure didn't change.

The court did not mention the proposed regulations, but even if they had been taken into account the outcome of the case would have been the same. Member-managed LLCs are subject to self-employment tax because all members have management authority. It's that simple. In addition, as noted below, there is an exception in the proposed regulations that would have come into play.

Note: As a side-note, the IRS had claimed that the attorney trust funds were taxable to the PLLC. The court, however, disagreed because the lawyers were not entitled to the funds.

Structuring to Minimize Self-Employment Tax – The Manager-Managed LLC

There is an entity structure that can minimize self-employment tax. An LLC can be structured as a manager-managed LLC with two membership classes. With that approach, the income of a member holding a manager's interest is subject to self-employment tax, but if non-managers that participate less than 500 hours in the LLC's business hold at least 20 percent of the LLC interests, then any non-manager interests held by members that participate *more* than 500 hours in the LLC's business are *not* subject to self-employment tax on the pass-through income attributable to their LLC interest. *Prop. Treas. Reg. §1.1402(a)-2(h)(4).* They do, however, have self-employment tax on any guaranteed payments.

Service businesses. The manager-managed structure does not achieve self-employment tax savings for personal service businesses, such as the one involved in *Castigliola*. Prop. Treas. Reg. §1.1402(a)-2(h)(5) provides an exception for service partners in a service partnership. Such partners cannot be a limited partner under Prop Treas. Reg. §1.1402(a)-2(h)(4) (or (2) or (3), for that matter). Thus, for a professional services partnership (such as the law firm at issue in the case), structuring as a manager-managed LLC would have no beneficial impact on self-employment tax liability.

Note: If a member of a services partnership (e.g. LLC) is merely an investor that is not involved in the operations of the LLC as a business *and is separately paid for services rendered,* any distributive share is

not subject to self-employment tax. *See, e.g., Hardy v. Comr., T.C. Memo. 2017-16.* But, if the distributive share is received from fees from the LLC's business, the distributive share is subject to self-employment tax. *See, e.g., Renkemeyer, Campbell & Weaver, LLP, 136 T.C 137 (2011).*

Farming and ranching operations. For LLCs that are not a "service partnership," such as a farming operation, it is possible to structure the business as a manager-managed LLC with a member holding both manager and non-manager interests that can be bifurcated. The result is that a member holding both manager and non-manager interests is not subject to self-employment tax on the non-manager interest but is subject to self-employment tax on the pass-through income and a guaranteed payment attributable to the manager interest.

Example. Here's what it might look like for a farming operation:

A married couple operates a farming business as an LLC. The wife works full-time off the farm and does not participate in the farming operation. But she holds a 49 percent non-manager ownership interest in the LLC. The husband conducts the farming operation full-time and also holds a 49 percent non-manager interest. But, the husband, as the farmer, also holds a 2 percent manager interest. The husband receives a guaranteed payment for his manager interest that equates to reasonable compensation for his services (labor and management) provided to the LLC. The result is that the LLC's income will be shared pro-rata according to the ownership percentages with the income attributable to the non-manager interests (98 percent) not subject to self-employment tax. The two percent manager interest is subject to self-employment tax along with the guaranteed payment that the husband receives. This produces a much better self-employment tax result than if the farming operation were structured as a member-managed LLC.

Additional benefit. There is another potential benefit of utilizing the manager-managed LLC structure. Until the net investment income tax of I.R.C. §1411 is repealed, it applies to a taxpayer's passive sources of income when adjusted gross income exceeds $250,000 on a joint return ($200,000 for a single return). While a non-manager's interest in a manager-managed LLC is typically considered passive with the income from the interest potentially subject to the 3.8 percent surtax, a spouse can take into account the material participation of a spouse who is the manager. *I.R.C. §469(h)(5).* Thus, the material participation of the manager-spouse converts the income attributable to the non-manager interest of the other spouse from passive to active income that will not be subject to the 3.8 percent surtax.

Note: Returning to the example above, the result would be that self-employment tax is significantly reduced (it's limited to 15.3 percent of the husband's reasonable compensation (in the form of a guaranteed payment) and his two percent manager interest) and the net investment income surtax is avoided on the wife's income.

Soroban Capital Partners LP

The Tax Court has now issued a fully reported opinion (meaning it is of national significance in all jurisdictions) taking *Castigliola* one step further and holding that creating a limited partner interest under state law is not necessarily enough to have a limited partner interest for self-employment tax

purposes. *Soroban Capital Partners LP v. Comr., 161 T.C. No. 12 (2023).* The petitioner was a limited partnership that made guaranteed payments and distributed ordinary income to its limited partners. However, the petitioner excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interest conformed to state law. The IRS disagreed asserting that wasn't enough and that the functions and roles of the limited partners also had to be analyzed for self-employment tax purposes. The Tax Court agreed with the IRS.

The Tax Court was faced with the definition of a "limited partner" for purpose of the exception from s.e. tax under I.R.C. §1402(a)(13). The Tax Court noted that the proposed regulations provided a definition, that the Congress froze the finalization of the regulation for six months and has said very little about the issue since the freeze was lifted, and has not provided a definition. The Tax Court noted that it had applied a "functional analysis" test in *Renkemeyer*, but that this was the first time the Tax Court was asked to determine the self-employment tax status of limited partner in a state law limited partnership (having passed on the issue in a 2020 case). The Tax Court determined that the functional analysis test applied based largely on statutory construction of I.R.C. §1402(a)(13) which excludes from self-employment tax "the distributive share of any item of income or loss of a limited partner, as such." The Court concluded that the "as such" language meant that there wasn't a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner that is acting as a limited partner. If a limited partner is anything more than merely an investor, self-employment tax applies to the partner's distributive share.

Note: The court noted that the petitioner cited legislative history in an attempt to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that the petitioner put forth "myriad other arguments" none of which were persuasive. The petitioner even cited language in the instructions for Form 1065 which it claimed defined a limited partner, but the Tax Court noted that the definition did not purport to define a limited partner.

The Tax Court held that a functional inquiry into the roles and activities of the petitioner's individual partners under I.R.C. §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied the petitioner's motion for summary judgment and set forth the rule going forward in evaluating the application of self-employment tax for limited partners in professional service businesses.

Conclusion

The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For those that are, such as the PLLC in *Castigliola,* the S corporation is the business form to use to achieve a better tax result. For an S corporation, "reasonable" compensation will need to be paid subject to S.E. tax, but the balance drawn from the entity can be received self-employment tax free. But, for farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than the use of an S corporation because of the ability to eliminate the net investment income tax.

Of course, the self-employment tax and the net investment income tax are only two pieces of the puzzle to an overall business plan. Other non-tax considerations may carry more weight in a particular situation. But for some, this strategy can be quite beneficial.

The decision in *Castigliola* would appear to further bolster the manager-managed approach – an individual that is a "mere member" appears to now have an even stronger argument for limited partner treatment. In addition, the court didn't impose penalties on the PLLC because of reliance on an experienced professional for their filing position.

Soroban Capital Partners LP lays down the rule that it's not enough to simply hold a limited partnership interest under state law (in the context of a professional service business). A limited partner must truly be acting as an investor and no more. The case involves a limited partnership that performs professional services, so it's fairly easy for the IRS to assert s.e. tax. The opinion really doesn't address whether you can be a passive investor with some services provided to the limited partnership and still have it exempt from s.e. tax. It also doesn't address whether you can be both a general partner and a limited partner and avoid s.e. tax on the income distributive share attributable to the limited partner interest. The answer to those last two questions, according to the analysis provided above, should be "yes" for farm and ranch clients.

Will Steve Cohen now move to try to settle his case with the IRS? Are the limited partners in his hedge fund business truly limited partner investors? Doubtful.

Proper structuring of the LLC and careful drafting of the operating agreement is important.