

## insights

TYPES NOT MAPPED YET March 28, 2017 | TTR not mapped yet | Steve B. Gorin

# Tax court finds no self-employment tax for passive LLC member

Self-employment (SE) tax is one of the driving forces when a tax advisor recommends what type of entity to use for one's business. This article describes SE tax, lists some common exceptions, explains the suggestion that an interest in a limited liability company (LLC) can avoid SE tax, then analyzes a recent case in which, for the first time ever, the Tax Court held that an LLC member's income was not subject to SE tax.

### What is self-employment tax?

SE tax is the combination of employer and employee FICA (Social Security and Medicare) tax. For 2017, the SE tax rate is 15.3% on the first \$127,200 of an individual's SE income, then 2.9% until the individual's SE income reaches \$200,000 (single) or \$250,000 (married), then finally 3.8% on any excess.

A business owner pays SE tax on business income earned directly or through a partnership. For income tax purposes, generally an LLC is either disregarded or treated as a partnership. When a person owns an S corporation, their compensation is subject to FICA, but their share of the corporation's income as an owner is not subject to FICA or SE tax.

### SE considerations for limited partnerships, LLCs

Special rules apply to limited partnerships. A limited partnership is a registered entity that vests authority to run the business in one or more general partners and is also owned by one or more limited partners who do not have authority to run the business. The SE tax rules treat limited partners similarly to S corporation owners: Any compensation income is subject to SE tax, but their share of partnership income is not subject to SE tax. A limited partner who is also a general partner is subject to SE tax on partnership income received as a general partner but remains not subject to SE tax on the partnership's income received as a limited partner.

How about LLCs? An LLC's control may be vested in its members (owners) or managers. A manager may or may not be a member. Many tax advisors view members who have control rights as general partners, whether the control is because the LLC vests control in its members or because the members are also managers. Conversely, when an LLC vests control in its managers, and a member is not a manager, many tax advisors would view such a member as equivalent to a limited partner.

The latter view of a member as a limited partner is not based on any exception described specifically in any statute. Rather, it is based on an analogy, one supported by the IRS' informal administrative practice but never fully embraced by the IRS in any way upon which taxpayers are entitled to rely.

### The *Hardy* decision

However, *Hardy v. Commissioner*, [Tax Court Memorandum 2017-16](#), had a surprising result. Together with seven other equal owners, the taxpayer owned an LLC that operated a surgery center. Each member was also a manager; together they controlled the LLC. They delegated daily operations to an employee, who professionally ran the surgery center. In determining whether the taxpayer's income from the LLC was "passive," the judge focused on actual daily management of the business rather than the taxpayer's legal rights to manage the LLC together with the other equal owners. Based on this focus, the judge treated the taxpayer as a limited partner eligible for the exclusion from SE tax.

This approach appears to contradict the approaches taken in two other Tax Court cases, *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, [136 T.C. 137](#) (2011), and *Methvin v. Commissioner*, [T.C. Memo. 2015-81](#). As a "regular" Tax Court case, *Renkemeyer* has stronger precedential value than *Hardy* or *Methvin*. Also,

in [CCA 201436049](#) (not precedent but a good indication of where the IRS stands), the IRS refused to apply the limited partner exception to an LLC's active owner but implicitly accepted its application to an inactive owner.

Given the state of the law, those who wish to have certainty in avoiding SE tax should consider conducting business through a limited partnership, either directly or through an LLC owned by the limited partnership. However, many tax advisors will suggest taking a risk and directly using an LLC. Whether those who heed that advice will attain the result they seek remains to be seen.

I provided some additional in-depth commentary on the *Hardy* ruling for Steve Leimberg's Business Entities Newsletter: [Steve Gorin on Hardy v. Commissioner](#).

If these ideas intrigue you, consider calling me or, if you are a CPA, lawyer, trust officer, family office professional, or financial advisor, subscribing to my quarterly "[Gorin's Business Succession Solutions](#)" newsletter. Technical materials are available to qualified advisors analyzing the above more fully and comparing S corporations as alternative vehicles.

To place this case in context, see [Developments in FICA and self-employment tax affect partners and S corporations](#).

This article is not intended to provide legal or tax advice. Please consult an appropriate professional to advise you whether these ideas might help your particular situation.

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