We Made an S Election to Save Self-Employment Taxes

By **MARCUS J. BROOKS** and **TRIP DYER**

Above is the most oft-cited reason for having partnership-eligible state law entity, typically a limited liability company (LLC), make an S election. There are times that this principle holds up. There are, however, many situations in which it does not bear out. There are also situations in which any self-employment tax savings from making an S election may be outweighed by restrictions on, or consequences of, S corporation status, which do not apply to entities taxable as partnerships.

In this article, we will try to set forth some more-or-less quantitative measures by which to evaluate that proposition, as well as considering whether a traditional limited partnership (LP) or multi-entity planning might reach a more optimal overall result.

Self-Employment Tax

Individuals are generally subject to self-employment tax on their self-employment income. In 2017, the self-employment tax rate was 15.3 percent on self-employment income up to $127,200 and 2.9 percent on all income in excess of $127,200. An additional 0.9 percent Medicare tax is imposed on self-employment income exceeding $250,000 for married couples filing jointly, $125,000 for married couples filing separately and $200,000 for single filers. In the aggregate, this results in a 3.8 percent rate on high income taxpayers for all self-employment income over and above the aforementioned limits.

Self-employment income, or "net earnings from self-employment," includes the gross income derived by an individual from any trade or business conducted as a sole proprietorship or partnership in which the individual is a partner, less certain deductions. However, in determining an individual's self-employment income, there is a specific exclusion for a limited partner's allocable share of income from a partnership other than guaranteed payments made to a limited partner for services provided to a partnership.

Section 1402(a)(13) was passed in 1977, before the advent of LLCs and limited liability partnerships (LLPs). Prior to its enactment, a limited partner's share of partnership income was treated as self-employment income. The legislative history indicates that the purpose of section 1402(a)(13) was to prevent limited partners who performed no services for a partnership from accruing Social Security benefits. Guaranteed payments for services actually performed by a limited partner for the partnership, however, were subject to self-employment taxes. The statute was thus designed as a "blocker" from persons who ostensibly desired to

continued on next page

pay self-employment taxes without performing services and receive credit for Social Security purposes, rather than as a tax planning technique to avoid self-employment taxes.

The legislative history also indicates that where the same person is a limited partner and general partner in the same partnership, the income attributable to the general partner interest would be subject to self-employment tax, but the income attributable to the limited partner interest would not.

The Limited Partner Exclusion, as Applied to LLCs, LLPs, etc.

Although the limited partner exclusion in section 1402(a)(13) may appear to be a useful vehicle for escaping self-employment taxes, its application to persons other than traditional limited partners in a state law LP has been uncertain, at best. A string of cases and rulings indicates that the IRS is not willing to accept the limited partner exclusion at face value, particularly in situations involving LLCs and LLPs. Courts have then struggled to draw uniform principles that would guide taxpayers in these situations. A review of a few of the cases in this area is instructive.

> A string of cases and rulings indicates that the IRS is not willing to accept the limited partner exclusion at face value …

Renkemeyer, Campbell & Weaver LLP v. Comm'r, 136 TC 137 (2011) may be the most discussed case in this area. In Renkemeyer, the Tax Court held that partners of a law firm, which was organized as an LLP (under state law, a general partnership in which all partners are shielded from liability) were subject to self-employment taxes on their shares of partnership income. The partners argued that the limited partner exclusion applied, because their interests were designated as limited partnership interests in the partnership agreement and they had limited liability under state law. The Tax Court noted that section 1402(a)(13) does not define "limited partner" and that the meaning of the term has been obscured as new types of flow-through entities, such as LLCs and LLPs, became commonplace.

Because the legislative history of section 1402(a)(13) indicates that the purpose of the limited partner exclusion was to ensure that merely passive investors would not receive credits towards Social Security coverage, the court found that the limited partner exclusion should not apply to partners who performed services for a partnership in their capacity as partners. The partners were subject to self-employment tax on all of their partnership income, because their earnings were not of an investment nature; their income all arose from their legal services and they made only nominal capital contributions to the partnership. The court did not rest its holding on the notion that partner in an LLP could not be "limited partners," nor did it deal with the concept of guaranteed payments.

Howell v. Comm'r, TC Memo 2012-303, addressed the application of section 1402(a)(13) as it applied to a member of a California LLC holding a medical technology company that was operated by a husband and wife as members. The Tax Court followed the general approach of Renkemeyer, but arguably added some important nuance. The taxpayers initially characterized payments made to Mrs. Howell as guaranteed payments, which would on its face bring the payments outside of the exclusion. At trial, the taxpayers took the position that these payments were not "guaranteed payments" and should thus be recharacterized.

The Tax Court concluded that Mrs. Howell performed services for the company, was not "merely" a passive investor and that the payments were at least "to some extent" payments for services rendered. Because the taxpayers did not attempt to establish that only some portion of the payments was remuneration for services rendered, the court found wholly for the IRS.

Again, this opinion does not close the door on the idea that LLC members (even working LLC members) might utilize the limited partner exclusion. If the simple fact that Mrs. Howell performed services had taken her out of the limited partner exclusion, by definition, then the guaranteed payment analysis provided for in the statute would not have been necessary. This opinion at least raised the question of whether an LLC member's compensation can be bifurcated, with some being for services rendered and thus subject to self-employment taxes, while other amounts may be due to ownership/investment and subject to exclusion under section 1402(a)(13).

Castigliola v. Comm'r, TC Memo 2017-62, addressed whether the limited partner exclusion applied to members of a law firm organized as a member-managed LLC, who had improved on the taxpayers' arguments in Renkemeyer and Howell by paying themselves guaranteed payments that were commensurate with local legal salaries. These members took the position that their shares of LLC income above such payments were excluded from self-employment taxes under section 1402(a)(13).

The Tax Court, generally following the Renkemeyer approach, determined whether the members of the LLC held a position that was "functionally equivalent to that of a limited partner in a limited partnership." Because each member in Castiogliola actively participated in the management of the business, the Tax Court held that they were not limited partners under section 1402(a)(13). The court reasoned that, since by necessity at least one of members must have occupied role analogous to that of general partner in a limited partnership and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners. As a result, all of their LLC income was subject to self-employment taxes.

The court did not analyze to what extent the members' remuneration was or was not due to services rendered, as in the Howell analysis, but rather rested its entire holding on the determination that the members were more like general

 continued from page 40

partners than limited partners. The easily asked question here is whether this analysis changes for a manager-managed LLC, where the members do not have responsibilities commensurate with a general partner.

We do know that there are situations in which an LLC member can effectively utilize the limited partner exclusion. In Hardy v. Comm'r, TC Memo 2017-16, the Tax Court addressed a fact pattern in which a surgeon was a minority member of an LLC that operated a surgical center. When the surgeon/member performed surgeries at the surgical center, patients would pay two fees: one to the surgeon/member for the surgery and one to the surgical center for use of the facility. The Tax Court noted that he was "not involved in the operations of the LLC as a business" and held that his share of LLC income (which was solely attributable to the surgical center fees) was not subject to self-employment tax because "he received the income in his capacity as an investor."

Taken together, these opinions establish that:

- An LLC member may be a "limited partner" under section 1402(a)(13) and
- Amounts paid to an LLC member based on such member's "investment" rather than in remuneration for services can fall under the exclusion.

The guaranteed payment analysis in Howell, as well as the language of section 1402(a)(13) itself, raises at least a reasonable argument that an LLC member who is a "limited partner" (e.g., an individual who is a member, but not a manager, of a manager-managed LLC) should be able to reasonably bifurcate his/her income between guaranteed payments for services, which would be subject to self-employment tax, and investment income, which would fall under the limited partner exclusion.

Net Investment Income Tax and Its Application to Partnerships

A taxpayer reporting income from an LLC taxed as a partnership may be able to escape self-employment taxes by utilizing some form of the Hardy passive investor strategy, but in so doing may simply walk into the net investment income tax (NIIT). The NIIT is imposed, in addition to income tax, at a 3.8 percent rate on the lesser of an individual's net investment income or adjusted gross income above certain thresholds, which thresholds are identical to those described above for the 0.9 percent Medicare tax on self-employment income. The NIIT essentially mirrors the uncapped self-employment tax burden described above.

Net investment income includes income from interest, dividends, annuities, royalties and rents. Importantly, it also includes income from a trade or business that is a passive activity within the meaning of section 469 with respect to a taxpayer. Under section 469, a passive activity is any trade or business in which a taxpayer does not materially participate.

Generally, a limited partner is not treated as materially participating in an activity unless he/she participates for more than 500 hours in a taxable year. A taxpayer who acts as a passive investor to escape self-employment taxes, like the surgeon in Hardy, could instead subject himself/herself to NIIT. The self-employment tax and NIIT rates on income above the threshold amounts are identical, so, with the exception of self-employment taxes up to the threshold amount, use of the limited partner exclusion by a passive taxpayer generally does not result in a significant tax savings.

Let's briefly consider this in conjunction with the hypothetical posited above – i.e., that an LLC member who is a "limited partner," (e.g., in a manager-managed LLC) should be able to support a reasonable bifurcation of income into the guaranteed payment for services bucket, on the one hand, and the investment bucket on the other. The latter portion (investment bucket) would not be subject to self-employment taxes. Would that latter portion then be subject to NIIT? Arguably, it would not, assuming the taxpayer materially participated in the LLC's trade or business, as it does not arise from a trade or business that is a passive activity with respect to a taxpayer.

Section 1411(c)(2)(A), describing activities that give rise to net investment income, states that "a trade or business is described in this paragraph if such trade or business is a passive activity (within the meaning of section 469) with respect to the taxpayer." Remember, the taxpayer is indisputably active and receiving a guaranteed payment for services. So, in this example, the LLC member has arguably succeeded in:

- Bifurcating its LLC compensation for self-employment tax purposes and
- avoiding the NIIT.

That said, it is not a stretch to say that the law in this area remains "messy" and, unfortunately, the definitive case is not yet out there. To fall squarely within the statute and avoid the uncertainty surrounding LLCs and LLPs, a traditional LP might be utilized instead. Section 1402(a)(13) clearly allows for a limited partner to bifurcate his/her income between guaranteed payments and investment income, avoiding self-employment tax on the latter. Assuming a limited partner materially participates in the LP's trade or business, he/she could avoid paying NIIT on his/her distributive share of income from the partnership, as well.

Additionally, an individual could arguably retain a role in management as a general partner without jeopardizing the exclusion of his/her limited partner income from self-employment tax based on the legislative history of Section 1402(a)(13). For these reasons, LPs are a viable option for self-employment tax and NIIT planning without making an S election, even though they may sometimes be less desirable than an LLC for non-tax reasons.

Self-Employment Tax and NIIT as Applied to S Corporation Owners

While S corporations do come with a variety of trade-offs and limitations, one thing that they do offer is relative clarity in this area. Unlike sole proprietorships and partnerships, a shareholder's share of income from an S corporation is not subject to self-employment taxes. A shareholder's share of income may, however, be subject to NIIT if the trade or business is a passive activity with respect to the shareholder. As a result, a passive shareholder of an S corporation would be subject to NIIT, just like a passive limited partner who utilized the limited partner exclusion to avoid self-employment taxes.

An S corporation shareholder can avoid both self-employment taxes and NIIT, though, if the trade or business is not a passive activity. If the shareholder materially participates in the activity under the rules of section 469, his/her

An S corporation must pay a shareholder who is active in the business reasonable compensation that is subject to payroll taxes.

share of income from the S corporation generally is not considered net investment income. Likewise, a shareholder's share of income from an S corporation is not subject to self-employment taxes.

There is one important gating issue to the above treatment – an S corporation must pay a shareholder who is active in the business reasonable compensation that is subject to payroll taxes. Because S corporation income is not subject to self-employment taxes, but compensation paid to an employee is subject to payroll taxes, S corporations with shareholder-employees are incentivized to forgo paying compensation and instead make distributions to its shareholders-employees.

Recognizing this, the IRS has taken to recharacterizing distributions made to shareholder-employees as compensation. A discussion on determining reasonable compensation for a shareholder-employee of an S corporation is beyond the scope of this article, but many factors should be considered, including the employee's qualifications, experience, and job scope and market compensation for similar positions. A tax advisor may consider factors found in cases in the C corporation context, where the IRS tends to argue that compensation paid to a shareholder is too high.

Other Considerations in Making an S Election/Multi-Entity Planning

In addition, S corporations have other disadvantages which must be weighed against any benefit derived in the self-employment tax/NIIT arena. S corporations are limited to 100 shareholders, all of whom must be US residents and individuals or certain types of trusts or estates. Businesses that have equity owners that are taxable as partnerships or corporations or that are nonresident aliens are not eligible to make an S corporation election.

Further, S corporations are limited to one class of stock. This means that each share of stock issued by an S corporation must have identical rights to distributions and proceeds from liquidation. Essentially, all distributions from S corporations must be made to the shareholders pro rata in accordance with percentage ownership.

Many distribution waterfall provisions common to LPs and LLCs, such as non-pro rata preferred returns or carried interests, are forbidden for S corporations. As a result, S corporations cannot issue profits interests to key employees that it would like to incentivize with equity ownership.

S corporations also have a more difficult task attracting outside investors, because many investors are organized as partnerships and are not eligible shareholders, and the corporation is hamstrung by the single class of stock requirement. Beyond the eligibility issue, purchasers of an S corporation interest do not receive a section 743 step-up in the inside basis in the entity's assets, as do the purchasers of a partnership interest. Additionally, built-in gain property (e.g., appreciated real estate or intellectual property) can present substantial difficulties in an S corporation, because moving it out of the S corporation structure may result in a deemed sale and taxable gain under section 311(b).

In this context, multi-entity planning should not be ignored. There may well be situations in which the S election drives certainty and self-employment tax/NIIT savings sufficient to justify the election, but in which other effects of the S election need to be mitigated. To manage the S corporation restrictions, one possibility is for an S corporation to form a subsidiary in the form of an LLC. The subsidiary, which would not be subject to the same organizational rules as the S corporation, would be able to offer employees profits interests. It would also be positioned to bring in equity investors, no matter their organizational structure or residency, for any economic terms that are negotiated and to provide them with a section 743 step-up as to the assets underneath the partnership structure.

A subsidiary would also allow built-in gain property to be moved around as necessary within the partnership structure (though not outside of the upstream S corporation) without recognition of gain. The principal shareholder could avoid self-employment taxes and NIIT on his/her distributive share of S corporation income (which would flow through the subsidiary to the S corporation), as long as he/she materially participates in the trade or business and was paid a reasonable salary by the S corporation.

Consider the Drawbacks

An S election can certainly offer savings, given the correct situation, and certainty with respect to self-employment taxes and NIIT. However, the amount of those savings should be quantified, as far as possible, and weighed against the potential drawbacks of making an S election. Those drawbacks may be significant or insignificant, depending on the type of business, property, investors and long-term strategy involved.

When substantial competing interests come into play here, do not forget to consider a traditional LP or whether a multi-entity strategy can provide the best overall solution. While there are reasonable arguments that the proper use of an LLC taxed as a partnership should get you to the same self-employment tax and NIIT treatment as an S corporation, the state of the law regarding self-employment tax and NIIT as it relates to any entity taxed as a partnership, other than an LP, unfortunately remains unclear.

ABOUT THE AUTHORS:

MARCUS J. BROOKS
is a shareholder with Winstead, PC and a member of Winstead's Taxation, Employee Benefits & Private Business Practice Group. His practice focuses on tax controversies and litigation, and tax planning at both the federal and state levels. Brooks also serves as an adjunct professor at Baylor Law School.

PRESTON "TRIP" DYER
is a member of Winstead's Taxation, Employee Benefits & Private Business Practice Group. His practice focuses on federal and state tax planning for business transactions. Dyer serves as a Vice Chair of the State Bar of Texas Partnership and Real Estate Tax Committee.