### Developments in FICA and Self-Employment Tax Affect Partners and S Corporations

Steven B. Gorin, a partner in Thompson Coburn LLP in St. Louis, and previous Shop Talk contributor, writes about important developments regarding the use of S corporations to avoid FICA tax and whether a member in an LLC that is taxed as a partnership can avoid self-employment tax:

"The IRS frequently tries to recharacterize S corporation distributions as compensation subject to employment taxes. The Service recently persuaded the Tax Court to dismiss, for lack of jurisdiction, cases in which the IRS recharacterized distributions in this manner.

First, some background: A corporation needs officers to run it, and officers generally are employees. See, e.g., Reg. 31.3121(d)-1(b); Rev. Ruls. 71-86, 1971-1 CB 285, 73-361, 1973-2 CB 331, and 82-83, 1982-1 CB 151; *Veterinary Surgical Consultants P.C.*, 117 TC 141 (2001) (consulting and surgical services provided to veterinarians); and *Spicer Accounting, Inc.*, 918 F.2d 90, 66 AFTR 2d 90-5806 (CA-9, 1990) (accounting firm).

(Editors' note: The IRS's Office of Chief Counsel issues legal advice to IRS personnel who are national program executives and managers in the form of Program Manager Technical Assistance (PMTAs). These are issued to assist IRS personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues, according to the IRS's website. (PMTAs cannot be used or cited as precedent.))

PMTA 2017-05 celebrated two cases which the Tax Court in 2017 dismissed for lack of jurisdiction to review the IRS's determination of whether payments to shareholder-employees were distributions or compensation: *Martin S. Azarian, P.A.,* Docket No. 28957-15, and *Patricia Arroyo DDS, Corp.,* Docket No. 5874-15. (The individuals in *Azarian* have a separate case pending in Tax Court, so they might as individuals be contesting the IRS's findings.) Thus, taxpayers disputing with the IRS whether payments are distributions or compensation may be relegated to paying the tax and suing for a refund. Instead of using litigation to defer payment and hoping to put pressure on the IRS to settle for a lower amount, taxpayers may need to pay the full amount upfront and wait for litigation to conclude, putting pressure on the taxpayer to settle for a less favorable result.

*Fleischer*, TCM. 2016-238, rebuffed a taxpayer's attempt to avoid self-em-

ployment (SE) tax by purporting to assign his earnings to his S corporation. The S corporation did not actually contract with those who paid compensation for the taxpayer's work, and the Tax Court had no sympathy for the high cost of qualifying the S corporation to enter into such contractual arrangements.

The IRS is also litigating self-employment (SE) tax cases. Since you reported on *Renkemeyer, Campbell and Weaver, LLP*, 136 TC 137 (2011), the IRS has issued two important CCAs and the Tax Court has issued three important Memorandum opinions in the area. (See Shop Talk, "Does *Renkemeyer's* Legacy of Confusion Live On?," 118 JTAX 99 (February 2013).) Key is the scope of the limited partner exception under Section 1402(a)(13), which *Renkemeyer* suggested could apply other than just to limited partners. (Editors' note: For more on *Renkemeyer*, see, e.g., Banoff, "*Renkemeyer* Compounds the Confusion in Characterizing Limited and General Partners—Parts 1 and 2," 115 JTAX 306 (December 2011) and 116 JTAX 300 (June 2012).)

CCA 201436049 refused to apply the limited partner exception to an LLC. The taxpayers tried to bifurcate their earnings, paying themselves reasonable compensation for services and reporting them on Forms W-2, taking the position that the LLC's remaining earnings were just as passive owners. CCA 201436049 might very well be the same case as *Castigliola*, TCM 2017-62, so I am discussing them together, given that the IRS won. The IRS and Tax Court pointed out that Rev. Rul. 69-184, 1969-1 CB 256, holds that compensation paid to partners constitutes Section 707(c) guaranteed payments; even though the IRS did not require the taxpayers to make adjustments regarding that incorrect W-2 reporting, the taxpayers could not say that they did not have SE income as partners. Furthermore, the taxpayers actively worked in the business, and there is no exception to SE tax for LLC members who control and run a business. (Editors' note: For more on ILM 201436049, see IRS Rulings, 121 JTAX 182 (October, 2014).)

CCA 201640014 is significant not only for what it did do but also what it didn't do. It ruled that LLC members who were active in the business could not claim limited partner status for any part of their distributive share of income, even if that business income was derived from investing capital and not from labor. Also significant is that the IRS tacitly accepted that the limited partner exception applied to an LLC member who was not involved in the business. The IRS noted the latter in passing and did not analyze it at all. (Editor's note: For more on ILM 201640014, see IRS Rulings, 125 JTAX 279, 280 (December 2016).)

Not so fortunate as the inactive LLC member in CCA 201640014 was the taxpayer in *Methvin*, TCM 2015-81, *aff'd* 653 Fed. Appx. 616, 117 AFTR2d 2016-2231 (CA-10, 2016). The latter taxpayer owned very small working interests in oil and gas ventures and had no right whatsoever to work in the business. The Tax Court said that participation does not matter. The limited partner exception does not appear to have been addressed, perhaps because the ventures were not held in LLCs or other limited liability entities.

More fortunate was Dr. Hardy, who along with seven other doctors held a 1/8 interest in a manager-managed LLC and was a member and a manager. See, *Hardy*, TCM 2017-16. However, Dr. Hardy's participation was merely that of an investor, as appeared to be the case for the other doctors, because they turned over daily operations to a full-time employee, who was not a manager but ran the LLC's daily operations. *Hardy* summarily held that the taxpayer was the equivalent of a limited partner whose distributive share was not subject to SE tax.

Unlike *Hardy*, *Castigliola* analyzed what it meant to be a limited partner. Judge Paris discussed the history of limited partnership law. When the members argued that no one member had control, Judge Paris pointed out that treatment as a limited partnership demands that someone have control as a general partner, and each member had management rights and in fact was active in the LLC's daily operations.

One wonders what would have happened if *Hardy* had been assigned to Judge Paris. In *Castigliola* , she did not accept the idea of ascribing limited partner status where no owner has legal control. The *Hardy* judge failed to analyze Dr. Hardy's management rights and refused to hear testimony about the members' legal rights. However, *Castigliola* involved active members and *Hardy* involved passive members, so the result if Judge Paris had decided *Hardy* is unclear.

From a tax return reporting viewpoint, *Hardy* provides authority for taking the position that the distributive share of a passive member in an LLC is not subject to SE tax. From a planning perspective, however, *Methvin* and *Castigliola* might suggest a different result, and using a limited partnership would provide the taxpayer with better arguments regarding one's distributive share of income as a state law limited partner.

Proposed tax reform deals with income tax rates—not FICA or SE taxes. However, under tax reform, wages might be subjected to higher income tax rates than distributive shares of pass-through entities, so tax reform may increase the significance of the character of distributions. Advising clients on FICA and SE tax avoidance will continue to be a robust planning area going forward—with or without possible enhancements from tax reform."

Your editors agree with Mr. Gorin's observation that current tax reform proposals may lead to greater emphasis on choice of form of entity to conduct business. That the tax tail may wag the dog and incentivize alternative entity structuring was considered long before LLCs, LLPs and LLLPs came into vogue. See, e.g., Banoff, "Reducing the Income Tax Burden for Professional Persons by Use of Corporations, Joint Ventures, Subpartnerships and Trusts," 57 Taxes 968 (December 1980).

We thank Mr. Gorin for his comments and welcome our readers' views on this timely topic. ●