

insights

TYPES NOT MAPPED YET May 25, 2017 | TTR not mapped yet | Steve B. Gorin

Tax court finds self-employment tax for active 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. My previous post, "[Tax court finds no self-employment tax for passive LLC member](#)," described SE tax, listed some common exceptions, explained the suggestion that an interest in a limited liability company (LLC) can avoid SE tax. The post also analyzed the *Hardy* case, in which, for the first time ever, the Tax Court held that an LLC member's income was not subject to SE tax, because the LLC member's income was protected by the limited partner exception from SE tax.

However, another recent Tax Court opinion, *Castigliola v. Commissioner*, [T.C. Memo. 2017-62](#), held that an active LLC member was liable for SE tax. This article describes that case, compares and contrasts that case to the *Hardy* case, and provides planning suggestions.

Castigliola v. Commissioner

In *Castigliola*, three lawyers were the only members and managers in a law firm organized as a member-managed LLC. They paid themselves compensation comparable to salaries at other law firms and properly reported that compensation as guaranteed payments. They claimed that the rest of the LLC's income arose from the work performed by the LLC's other employees and therefore was a return on investment, rather than SE income.

In the 1990s, when the IRS was trying to develop policy for how the limited partner exception might apply to LLCs, several in the tax world suggested the approach taken by the *Castigliola* taxpayers. However, it never became law, a minor detail the *Castigliola* taxpayers seem to have overlooked.

In *Castigliola*, Judge Paris suggested that LLC members may be taxed as limited partners if they had rights comparable to those of limited partners. She reviewed the history of limited partnership law, before, at the time of, and after (through now) the enactment of the limited partner exception. Every limited partnership has one or more general partners who run the business and one or more limited partners. She noted that the *Castigliola* taxpayers were the only owners, they ran the business, and they had only one type of ownership interest. Someone had to be the general partners, and they were it! Just as the lawyers in *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, [136 T.C. 137 \(2011\)](#), all of their distributive share of income was subject to SE tax.

Castigliola contrasted with *Hardy*

In both *Castigliola* and *Hardy*, the taxpayers were the sole members and sole managers in a manager-managed LLC. The *Hardy* judge refused to consider the owners' legal rights to manage the LLC and focused only on who actually ran the daily operations. If Judge Paris had presided over the case, I do not believe that she would have accepted the *Hardy* judge's unstated premise of an LLC that was like a limited partnership but had no general partners. However, that case was not before her, because the *Hardy* taxpayers did not run the LLC's daily operations and the *Castigliola* taxpayers did.

Planning implications

Faced with an LLC whose members do not participate actively in daily operations, a tax advisor might conclude that *Hardy* applies and prepare a return reporting no SE income on the members' distributive share of income. However, from a planning perspective, 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. Others may advise setting up LLCs with various classes of ownership to make their situations different from *Castigliola*, but I suggest that they run the risk of their clients becoming a test case.



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.

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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