

TAX LETTER

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Employment Tax Issues of pass-through entities

The rules for Employment Tax vary somewhat between different types of pass-through entities and their owners. Presenting both possible costly outcomes and tax-saving opportunities. This article attempts to explain certain key employment tax rules applicable to a partnership, an S corporation, and a limited liability company (LLC).

Partnership. A partnership is generally defined as an association of two or more individuals together, as co-owners, carry on a business for profit. In *Galletti*, (2004), the Supreme Court held that IRS was entitled to collect a partnership's employment taxes from the individual partners. Under IRC Sec. 3403, the partnership was the "employer", the partners though not primarily but secondarily liable for the employment taxes, and the IRS was not required to assess the delinquent tax against each and every partner.

The Court rejected the argument that the partners were entitled to separate assessment. It held that a timely assessment of tax against the partnership by IRS extended the time period for collecting the debt in judicial proceedings against the partnership or partners. According to IRC Sec. 6501 and Sec. 6502 , the function of an assessment is to calculate and to record a tax liability and not assessing the taxpayer.

While IRC Sec. 1401 and Sec. 1402 impose a self-employment tax on a general partner's share of income distributed from the partnership's business, the IRC Sec. 1402(a)(13) excludes the distributive share of a limited partner from self-employment taxes unless it was distributed as guaranteed payments. Pursuant to IRC Sec. 707(c), guaranteed payments are payments made by the partnership to partners for services rendered to the partnership or for the use of capital, without regard to the partnership's income. Guaranteed payments, therefore, are considered to be made to a recipient may or may not be a member of the partnership.

To clarify the self-employment status of limited partners, recently IRS made a proposed amendment to Reg. § 1.1402(a)-2(h)(2). Under this proposed amendment, an individual is treated as a limited partner, for employment tax status purposes, unless the partner either:

(1) has personal liability for the debts of or claims against the partnership by reason of being a partner;

(2) has authority to contract on behalf of the partnership; **or**

(3) participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

An exception in the proposed amendments is that a partner who provides services to or on behalf of a professional service partnership is not treated as a limited partner for self-employment tax purposes. Also, a partner is not a service partner if that partner provides only "de minimis" services to or on behalf of the partnership. A professional service partnership is one in which substantially all the activities involve the performance of services in the fields, such as medicine, law, engineering, architecture, accounting, actuarial, or consulting.

S corporations. An S corporation is a small business corporation, which its shareholders consent to be taxed under subchapter S. Despite arguments from three S corporations that they should not be held liable for payroll taxes on payments to their shareholders for services performed by them, these entities were held liable by the Tax Court. In an unpublished opinion, the Third Circuit, affirming all three Tax Court decisions. The Court held that the presidents of those three corporations, who handled the companies' business transactions and were also shareholders in the corporations, were employees. The Court also ruled that a similar situation occurred in Nu-Look Design, Inc. (CA 3 2004), where the shareholder/officer performed services and was held to be liable for employment taxes.

However, if shareholders/officers performed minor services and neither received nor were entitled to receive any compensation, they would not be employees for federal unemployment tax purposes.

Limited liability Company, LLC. An LLC is a hybrid entity created under state law having certain attributes of a partnership and a corporation. IRS treats an LLC as an eligible entity under the "check-the-box" rules, whereby an LLC has the flexibility to be classified as either a partnership, an association taxable as a corporation, or a disregarded entity.

To be continued

Next month we will discuss the employment tax issues surrounding single member LLC and multiple members LLC.