

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

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THE "TWO-CLASSES-OF-INTERESTS" RULE: PROTECTING MANAGERS OF MULTI-MEMBER LLCs FROM SELF-EMPLOYMENT TAXES

EXECUTIVE SUMMARY. Internal Revenue Service guidelines under Prop. Reg. §1.1402(a)-2 make it possible to protect individuals who are managers of multi-member LLCs taxable as partnerships from liability for the Self-Employment Tax (the "SET"). These guidelines can provide major Social Security tax savings not only for managers of both large LLCs but also for managers of very small ones.

DISCUSSION.

- 1) The federal income tax regimen of multi-member LLCs. Under the U.S. Treasury Department entity classification rules known as the Check-the-Box Regulations, multi-member LLCs can choose to be taxable as C corporations, as S corporations or as partnerships taxable under Internal Revenue Code Subchapter K. The default federal income tax regimen for multi-member LLCs under these rules is, of course, partnership taxation.
- 2) The Prop. Reg. three-test rule. The IRS guidelines determining the liability of individuals who are members of multi-member LLCs taxable as partnerships are set forth in Prop. Reg. §1.1402(a)-2 (the "Prop. Reg."). Under the Prop. Reg., individuals who are members of multi-member LLCs must, in general, pay SET on their distributive shares of LLC income unless they meet each of the following three tests:
 - a) They lack personal liability for the obligations of their LLC.
 - b) They work for 500 or fewer hours for the LLC during the LLC's taxable year.
 - c) They lack LLC agency authority—that is, under the governing LLC act, they have no authority to sign contracts that bind the LLC.

For a detailed discussion of these three tests, see Issue 20 of this Newsletter. To access Issue 20, click on www.llcformations.com; then click on button marked "LLC Newsletter Archives."

- 3) The SET problem of LLC investors who are also LLC managers. Passive investors in LLCs generally have no problem passing each of the above Prop. Reg. tests. However, many individuals who are members of multi-member LLCs are also managers of these LLCs and thus, under the governing LLC act, necessarily have LLC agency authority. In addition, many such individuals work for more than 500 hours a year for their LLCs. What if, as is often the case, these LLC manager-

members are also investors in their LLCs and are likely to derive substantial investment income from them?

EXAMPLE. Mary Roe is the manager of XYZ, LLC, a three-member LLC that has been formed to develop and sell an office building. Mary has also contributed \$500,000 to XYZ, amounting to one-third of XYZ's investment capital. Mary's annual guaranteed payment for her XYZ management services is \$100,000. When XYZ sells the developed office building, its net income is \$3 million, all of which is ordinary income. Mary's distributive share of this \$3 million is \$1 million.

Because Mary is an agent of XYZ and works for XYZ for more than 500 hours in each of its taxable years, does she have to pay SET on this \$1 million? In Mary's case, this SET liability would be roughly \$29,000.

- 4) The "two-classes-of-interests" exception to the Prop. Reg. three-test rule. Fortunately for Mary, the Prop. Reg. contains an exception to the above three-test rule that will protect her from SET on her distributive share of XYZ's income. (She must, of course, pay SET on her guaranteed payment from XYZ.) The key elements of this exception—which will be referred to here as the "two-classes-of-interests rule"—are as follows:
- a) The multi-member LLC in question must have at least two classes of interests. (In drafting LLC operating agreements to comply with the two-classes-of-interests rule, I call these classes the "manager class" and the "investor class.")
 - b) A substantial continuing portion of the interests in one of the above classes (the "investor class") must be held by one or more LLC members who meet all of the above three tests. The Prop. Reg. provides a safe harbor under which this "substantial continuing portion" rule will be met if at least 20% of the interests in the investor class are held by persons that meet all of the above three tests.
 - c) If the above requirements are met, then individuals who hold interests in the above investor class will be exempt from SET on their distributive shares of LLC income allocated to that class even if they fail one or more of the above three Prop. Reg. tests.
- 5) The importance of the two-classes-of-interests rule to small LLCs. The two-classes-of-interests rule is important to individuals like Mary Roe who are both managers of and investors in highly profitable multi-member LLCs. It can also be important—indeed, in some ways, far more important—to individuals who are owners of multi-member LLCs that conduct relatively small businesses. This is because, as most readers will know, the SET applies in 2005 at a rate of 15.3% to the first \$90,000 of earned income but at a rate of only 2.9% to any excess. The LLC-related earned income of many individuals who own small LLCs is well under \$90,000.

EXAMPLE. John Doe and his wife Anne are equal owners of ABC, LLC, a two-member LLC that owns and operates a convenience store. ABC's annual net income averages \$90,000 year before compensation to John or Anne. John is ABC's manager and works full-time for it. John thus flunks two of the above

three Prop. Reg. tests. Anne keeps ABC's books but has no ABC agency authority and works for ABC for fewer than 500 hours a year. She thus passes all three of these tests. ABC pays John an annual guaranteed payment equivalent to what it would pay a third party to perform John's responsibilities for it—namely, \$35,000. ABC pays Anne a guaranteed payment of \$5,000 a year. Under ABC's operating agreement, ABC has two classes of interests—namely, a manager class, of which John is the sole owner, and an investor class, of which John and Anne are equal owners. ABC allocates \$500 of its annual net income to its manager class and the remainder to the investor class.

Under the above operating agreement arrangements, John's annual SET savings will, of course, vary with ABC's annual results. However, in any given year, these savings are likely to amount to several thousand dollars.

- 6) Subchapter S vs. Subchapter K. The managers of multi-member LLCs can also avoid Social Security taxes on their distributive shares of LLC income if their LLC elects to be taxable as an S corporation. This is because the net income of an S corporation is not subject to Social Security taxes. For multi-member LLCs, this method of avoiding Social Security taxes is often substantially simpler to implement than the method provided under the Prop. Reg. The issue of when LLCs should choose to be taxable as S corporations and when they should choose to be taxable as partnerships will be addressed in a soon-forthcoming issue of this Newsletter.

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