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GUIDELINES FOR ADVISING INDIVIDUALS WHO ARE MEMBERS OF LLCs TAXABLE AS PARTNERSHIPS ON HOW TO MINIMIZE SOCIAL SECURITY TAXES ON THEIR DISTRIBUTIVE SHARES OF LLC INCOME

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I. INTRODUCTION AND SUMMARY

A. Introduction; the purpose of this memorandum

On January 13, 1997, the IRS issued a proposed IRS regulation (officially designated Prop. Reg. §1.1402(a)-2, but referred to in this memo for brevity as the "Prop. Reg.") addressing the SET liability of individuals who are LLC members on their LLC income. The Prop. Reg. is presently the only federal tax authority on this issue.

My purpose in this memo is to provide practical guidelines for individuals who are LLC members on how to use the Prop. Reg. to minimize Social Security Taxes on their LLC income.[1] For completeness, I will also briefly compare the advantages and disadvantages of

[1] LLCs can have either a single member or multiple members, and multi-member LLCs can be taxable as partnerships (the default tax treatment under the Check-the-Box Regulations), as S corporations or as C corporations. Except as otherwise stated, all references in this memorandum to LLCs will refer to multi-member LLCs taxable as partnerships.

The Prop. Reg. addresses the SET liability not only of members of LLCs but also of persons with ownership interests in all other types of multi-owner unincorporated business entities, including limited liability partnerships, limited partnerships, limited liability limited partnerships, and statutory business trusts. This memo will discuss the Prop. Reg. only as applicable to multi-member LLCs. However, the guidelines set forth in the memo should be understood to apply to multi-owner unincorporated business entities in general and not just to LLCs.

the Prop. Reg. with those of Internal Revenue Code Subchapter S for Social Security Tax avoidance.

B. Summary of the key points in the memorandum

The following is a brief summary of the essential points in this memorandum:

1) The Prop. Reg. is the IRS's audit guideline in LLC SET matters. Although the Prop. Reg. is only a *proposed* regulation, it is highly probable that in any audit of the SET liability of an LLC member, the IRS will use the Prop. Reg. as its only audit guideline.

2) Binding effect of Prop. Reg. on IRS in litigation. In litigation of LLC SET matters, the courts will probably treat the Prop. Reg. as binding on the IRS with regard to all SET issues addressed by the Prop. Reg.

3) Binding effect of Prop. Reg. on LLC members in litigation. In litigation of LLC SET matters, the courts will probably treat the Prop. Reg. as binding on LLC members only to the extent that the courts determine that the specific rules of the Prop. Reg. relevant to the litigation are reasonable.

4) The Prop. Reg. does not protect single-member LLCs from Social Security Taxes. The Prop. Reg. applies only to individuals who are members of multi-member LLCs and not to those who are members of single-member LLCs. Individuals who are members of single-member LLCs and who want to reduce their Social Security Tax burden should either convert their LLCs to multi-member LLCs taxable as partnerships or should make S elections. The best second member for a single-member LLC whose member cannot make an S election or chooses not to do so is often the member's spouse or child.

5) Four types of LLC income are exempt from Social Security Taxes without any need to rely on the Prop. Reg. LLC income of four principal kinds – namely, (i) interest, (ii) dividends, (ii) capital gains and certain other gains from dispositions of property, (iii) real estate rentals and (iv) "limited partner" income – is statutorily exempt from Social Security Taxes. For individuals who are members of single-member LLCs and multi-member LLCs that earn only these types of income, the Prop. Reg. is unnecessary and irrelevant in planning for Social Security Tax avoidance.

6) SET avoidance by passive investors in LLCs. The Prop. Reg. provides four clear and generally reasonable tests – namely, the "personal liability" test, the "contract authority" test, the "500-hour test and the "service partner" test – for determining whether passive members of LLCs are liable for SET on their LLC income. By reason of these tests, this liability should never arise for passive investors in LLCs.

7) Impact of the contract authority rule. However, under the contract authority test, members of LLCs whose articles of organization fail to provide that these LLCs are "manager-managed" owe SET on their entire LLC income. The contract authority test is a major SET pitfall for LLC members. It is probable that by reason of their failure to comply with this test, tens or even hundreds of thousands of LLC members are subject to SET on LLC income that, if their LLCs were properly structured, they could partially or entirely avoid.

8) SET avoidance by LLC non-manager members who want to avoid SET on their LLC income. The Prop. Reg. provides a generally clear and reasonable rule – namely, the "single-class-of-interest rule"—for use in determining the SET liability of LLC

members on their LLC income in the rare circumstance in which these members work for more than 500 hours for their LLC in a given LLC taxable year but are not managers of the LLC. Under this rule, these members can generally avoid SET.

9) SET avoidance by LLC managers. The Prop. Reg. provides a clear and reasonable rule – namely, the "two-classes-of-interests" rule – for determining the SET liability of LLC members in the very common situation in which these members are simultaneous managers of their LLCs and investors in them. In this situation, these members will generally be able to use the two-classes-of-interests rule to achieve significant SET savings.

10) Aggressive use of the single-class-of-interest and two-classes-of-interests rules. LLC members who are willing to be aggressive in their interpretation of the single-class-of-interest and two-classes-of-interests rules can use these rules to realize very substantial SET savings, which may often significantly exceed the savings available under Subchapter S.

11) Two major unresolved issues under the Prop. Reg. However, there are two major unresolved issues under the single-class-of-interest rule and the two-classes-of-interests rule:

    a) The "need-for-investment" issue. The first issue is whether an LLC member may rely on the single-class-of-interest rule or the two-classes-of-interests rule if the LLC in question does not require significant capital investment. At least in extreme cases, the answer to this question is probably no.

    b) The "reasonable compensation" issue. The second issue is whether an LLC member may rely on these rules if the LLC in question pays the member substantially less than reasonable compensation for the member's services to or for the LLC. In many cases, the answer to this question is probably yes.[2],[3]

[2] Legal advantages of LLCs. In dealing with their clients about potential LLC advantages with respect to SET matters and other tax planning matters, tax professionals should consider touching at least briefly on the purely legal advantages of the LLC form. As many clients are likely to know, LLCs, like corporations and limited partnerships, provide a full liability shield to their members. However, LLCs also provide far greater legal flexibility than corporations, and, under so-called "charging order" protections, they provide a type of statutory business asset protection that corporations cannot provide. These charging order protections are a principal reason why knowledgeable business people and their professional advisers generally prefer LLCs over corporations as business entities.

[3] When should clients *not* seek to avoid Social Security Taxes? As indicated above, the focus of this memo is on using LLCs to avoid Social Security Taxes. There are some clients, especially those of modest means, for whom Social Security Tax avoidance may not be wise, since it may result in, among other things, a reduction in clients' retirement benefits and in their ability to make contributions to qualified plans. However, for many clients, Social Security Tax savings are a net benefit.

II. PROP. REG. §1.1402(a)-2 - BACKGROUND

A. The basics of Social Security Taxation insofar as relevant in understanding the Prop. Reg.

Under two separate but generally similar statutory regimens, Social Security taxation applies to all active income earned by, respectively, employees and self-employed individuals. The purpose of Social Security taxation is to fund the federal Old Age, Survivor and Disability Insurance program (paid for by the "OASDI" portion of the tax) and the federal Medicare old-age health program (funded by the "Medicare" portion). The underlying "pay-as-you-go" concept of the tax is that the benefits of the Social Security program should, in effect, be substitutes for the above active income for individuals no longer able to earn it, but that these benefits should also be financed by that income.[4]

Social Security taxation as applicable to employees is imposed under the Federal Insurance Compensation Act ("FICA"), IRC Section 3101 *et seq*. It is applicable to self-employed individuals under the Self-employment Tax Act ("SETA"), as imposed by IRC Section 1401 *et seq*. For SETA purposes, bona fide partners of tax partnerships are treated as self-employed individuals.

The OASDI portion of the tax applies at a rate of 12.4 percent and the Medicare portion at a 2.9 percent rate. For 2005, the 12.4 percent rate applies to the first $90,000 of active income; the 2.9 percent rate applies to any excess. Under FICA, the tax is split between employer and employee. Under SETA, the entire tax is paid by the self-employed individual in question. However, most economists would agree that since all employers effectively reduce their employees' wages by the employers' FICA, the economic impact of the tax on employees and on self-employed individuals is identical (except for a slight advantage to self-employed individuals arising from the fact that they are allowed to deduct one-half of their SET on their Schedule C).[5]

B. Section 1402(a)(13) and other subsections of Section Prop. Reg. §1.1402(a)-2 relevant to the Prop. Reg.; the ambiguity of the Section 1402(a)(13) term "limited partner"

Under Section 1402(a), the SET applies to "net earnings from self-employment" (NEFSE), defined as the income of individuals from their trade or business plus, in general, the distributive share of partners from their partnerships. However, various subsections of Section 1402(a)(1) through (16) exempt from the SET specified types of

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[4] Needless to say, a detailed discussion of the history and policy of the Social Security program and of the Social Security taxes that, in theory, support it is well beyond the scope of this memo. A good summary of this history and policy may be found in Fritz, "Flow-through Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?" 17 Virginia Tax Rev 811 (Spring 1998).

[5] The impact of this deduction on SET rates is shown in detail in an interesting table in Keatinge, Maxwell and Yearout, "Self-employment and Employment Tax Issues as They Relate to S Corporations, Partnerships and LLCs," ALI-ABA Publication VMF0317, Limited Liability Entities – 2005 – New Developments in Limited Liability Companies and Limited Liability Partnerships (March 17, 2005), pages 215-256, at page 225.

income traditionally viewed as passive income. For purposes of this memorandum, the relevant exemptions are:

- Income from the rental of real estate and personal property leased with real estate (except in the case of real estate dealers) (Section 1402(a)(1));
- Dividends on shares of stock and interest on indebtedness (Section 1402(a)(2));
- Certain gains, including capital gains (Section 1402(a)(3)); and
- Under Section 1402(a)(13), limited partners' distributive shares of limited partnership income.

Section 1402(a)(13) provides in its entirety as follows:

> The distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

Section 1402(a)(13) was enacted in 1977 and has not been amended since. The purpose of the section when enacted was, in essence, to prevent individuals from using limited partner passive income to increase their Social Security contributions and benefits.

In 1977, only two types of entities were taxable as partnerships under IRC Subchapter K – namely, general partnerships and limited partnerships. Moreover, limited partnership statutes were essentially identical in all states. Thus, as of 1977, identifying a limited partner for purposes of Section 1402(a)(13) was very easy.

However, since 1977, limited partnership law itself has evolved substantially, and the business organization law features of limited partners now vary significantly from one state limited partnership statute to another. Moreover, beginning in the early 1990's, several types of unincorporated business entities besides limited partnerships have emerged, including limited liability partnerships, limited liability limited partnerships ("LLLPs"), statutory business trusts, and, above all, LLCs.

As a result, it has become very difficult for the IRS to determine purely on the basis of the terms of Section 1402(a)(13) whether an individual who is a member of one of these unincorporated business entities should or should not be treated as a limited partner within the meaning of the section. For example, a member of an LLC is similar to a traditional limited partner in that the LLC member, like the limited partner, has statutory limited liability for his company's debt. However, an LLC member will retain this liability shield even if he or she participates fully in LLC decision-making and has the authority to sign LLC contracts. By contrast, limited partners may lose their liability shield if they participate in limited partnership management; and, as limited partners, they have no legal authority to sign limited partnership contracts.

The purpose of the Prop. Reg. is to define the Section 1402(a)(13) term "limited partner" as applicable to limited partners themselves under contemporary limited partnership

statutes and also as applicable to members of LLCs and other types of multi-owner unincorporated business entities taxable as partnerships.

As indicated in Part I.B of this memorandum, the Prop. Reg. sets forth four tests for determining whether a member of such an entity is a limited partner under Section 1402(a)(13), and it provides two rules – the single-class-of-interest rule and the two-classes-of-interests rule – under which LLC members may avoid SET even if they fail one or more of these tests. As discussed in Part VII, all of these Prop. Reg. provisions are likely to be binding on the IRS in any litigation of the SET liability of LLC members, but some of them may not be binding on LLC members except to the extent that the courts find them to be reasonable. In the following pages, I will explain each significant provision of the Prop. Reg. and will briefly state my view as to whether a court would be likely to treat it as binding.

III. THE FOUR TESTS UNDER THE PROP. REG. FOR DETERMINING WHETHER AN LLC MEMBER IS A LIMITED PARTNER FOR PURPOSES OF SECTION 1402(a)(13)

A. Are the Four Tests reasonable?

As noted above, in order to qualify as a limited partner under Section 1402(a)(13), an LLC member must pass each of four tests (the "Four Tests") – a personal liability test, a contract authority test, a 500-hour and a service partner test.[6] The preamble of the Prop. Reg. implies with reasonably clarity that, in setting forth these tests, the IRS's intent is, in general, to define as a limited partner under the Prop. Reg. any member of an LLC who lacks the characteristics of a general partner under traditional partnership statutory law or who, unlike a traditional general partner, performs no substantial services for the LLC.

In my view, it is highly likely that in litigation of an LLC member's SET liability, a court will deem the first three of the above Four Tests to be reasonable and thus to be binding not only on the IRS but also on LLC members. In addition, I believe that the court will be likely to agree with the IRS that a member's failure to meet *any* of these first three tests should suffice to prevent the member from being deemed to be a Section 1402(a)(13) limited partner.

However, for reasons discussed in Part III.E of this memorandum, I believe a court could well determine that the above "service partner" test as applied to many LLC members is not reasonable and thus should not be binding on these members in determining their SET liability.

B. The personal liability test

Under the personal liability test, as set forth in Prop. Reg. §1.1402(a)-2(h)(1), an individual who is a member of an LLC is not a limited partner if the individual "has

[6] Prop. Reg. §1.1402(a)-2(g).

personal liability for the debts of or claims against the partnership by reason of being a partner." Personal liability is defined in Prop. Reg. §1.1402(a)-2(h)(1) by reference to that term as defined in Section 301.7701-3(b)(2)(C)(ii) of the Entity Classification Regulations. Under those regulations, a member of an LLC has personal liability "if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such."

- Comment 1 – the unlikelihood that any LLC member will have personal liability for LLC debt. Under the mandatory rules of most LLC acts, all members lack personal liability for LLC debt; under the default rules of a few of these acts (including the New York Act), LLC members lack personal liability for LLC debts unless the operating agreement expressly provides otherwise.[7] However, since a principal reason why business founders form their businesses as LLCs is to provide themselves with limited liability, it is hard to imagine a situation in which an LLC member would opt out of this statutory liability shield. Thus, most or all individuals who are LLC members automatically meet the Prop. Reg. personal liability test.

- Comment 2 – effect of personal guarantees by the members under the personal liability test. It is not uncommon for individuals who are members of an LLC – and especially the more affluent members – to facilitate their LLC's business by granting personal guarantees for LLC lease obligations, bank debts or other LLC obligations. However, in my opinion, it is clear under the Prop. Reg. that the fact that an individual who is a member of an LLC provides a personal guarantee for one or more LLC debts does not cause the individual to fail the personal liability test. This is because the personal liability of a member of an LLC who guarantees an LLC debt has that liability not because of being a "member as such," but rather, as a guarantor bound by state common or statutory law governing guarantees.

C. The contract authority test

Under Prop. Reg. §1.1402(a)-2(h)(ii), a member of an LLC is not a limited partner within the meaning of the Prop. Reg. if the member "has authority (under the law of the jurisdiction in which the [LLC] is formed) to contract on behalf of the [LLC]."

- Comment 1 - relationship of Prop. Reg. §1.1402(a)-2(h)(ii) and the default rules of most LLC acts. As noted in Part I of this memorandum, under the default rules of most LLC acts, including the New York LLC Act, all members of an LLC, simply because they are members, have authority to act as agents of the LLC (i.e., to bind the LLC in contracts and in statements they make about the LLC) and to participate in the day-to-day management of the LLC. Under these acts, a member lacks contract authority and other LLC management rights only if the LLC's articles of organization (or a similar document under the applicable act) specifically provides that the management of the LLC is vested in one or

[7] A default provision of an LLC act is a provision that the act itself permits the members to alter in their operating agreement or otherwise; a mandatory provision is one that they may not alter.

more managers. If the articles of organization of a particular LLC do not so provide, then all members of the LLC are automatically subject to SET on their entire share of LLC income.

In order to determine whether a member of an LLC has contract authority under Prop. Reg. §1.1402(a)-2(h)(ii), it is necessary first to review the governing LLC act to determine whether the above statutory default rule applies under it; second, to review the articles of organization of the LLC to determine whether they alter the default rule; and third, to review the LLC's operating agreement and all related documents to ensure that no terms of these documents provide the member with contract authority under an agency delegation provision or otherwise.

- Comment 2 – the need of many LLCs to amend their articles of organization. In my experience, the great majority of LLC members and a significant majority of lawyers and tax professionals are unaware that all individuals who are the members of member-managed LLCs are automatically subject to SET on their shares of the LLC's income. My experience is also that many members of these LLCs do not want this SET liability and, by properly amending the articles of organization and operating agreements of their LLCs in accordance with the Prop. Reg., could readily avoid it.

- Comment 3 – contract authority under the Delaware Limited Liability Company Act. As noted above, under Prop. Reg. §1.1402(a)-2(h)(ii), an individual who is a member of an LLC is not a limited partner if the individual has contract authority "under the law of the jurisdiction in which the [LLC] is formed." The quoted phrase clearly refers to the governing LLC act of the relevant jurisdiction. The Delaware Limited Liability Company Act is generally viewed as the best U.S. LLC act from both a legal viewpoint and from the viewpoint of prestige.

  Under a default statutory rule contained in Section 18-402 of the Delaware Limited Liability Company Act, "[unless] otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company." It is arguably unclear whether a provision in the LLC agreement of an LLC formed under the Delaware Limited Liability Company Act that negates the contract authority of a member of that LLC does so "under the [Delaware Limited Liability Company Act]."

  In my opinion, the IRS itself and the courts would probably answer this question in the affirmative. However, the matter is not entirely without doubt. Thus, LLC founders who want to form their LLC under the Delaware Limited Liability Company Act because of its many legal advantages over other acts should be advised by their tax professionals that Section 18-402 poses at least an arguable risk of SET liability that other acts may not pose.

D. The 500-hour test

Under Prop. Reg. §1.1402(a)-2(h)(iii), an individual who is a member of an LLC is not a limited partner if the individual "participates in the [LLC's] trade or business for more

than 500 hours during the [LLC's] taxable year." Although the Prop. Reg. does not expressly say so, it is obvious that this 500-hour test is based on the 500-hour material participation test under Treas. Regs. Section 1.469-5T(a)(1).

- Comment – the 500-hour test and LLC record keeping. If the IRS were to assert an SET liability against an individual who was an LLC member, the individual would have the burden of proving that he or she had not worked for more than 500 hours during the relevant partnership taxable year. In many cases, the individual could probably bear this burden on the basis of testimony by other members of the LLC, including LLC managers, or on the basis of circumstantial evidence – for example, evidence that the individual was a mere investor in the LLC and was deeply involved in full-time professional or personal commitments unrelated to the business of the LLC. However, in rare instances, it may be appropriate for the LLC or one or more of its members to keep detailed records of the time they spend on LLC matters so as to have documentary evidence of their compliance with the 500-hour rule.

E. The service partner test

1) Description of the test. Under Prop. Reg. §1.1402(a)-2(h)(5), an individual who is a member of a "service partnership" and who participates to more than a de minimis degree in the trade or business of that partnership is not a limited partner under the Prop. Reg. for purposes of Section 1402(a)(13). Prop. Reg. §1.1402(a)-2(h)(6)(iii) defines as a service partnership any partnership "all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting." The definitions of some of these fields are reasonably self-evident, but some involve significant ambiguities. As shown below, where ambiguities exist, the definitions provided by the personal service corporation regulations under Section 1.448-1T are often helpful. These definitions are likely to be given careful consideration by the IRS and the courts in defining the scope of these fields.

- Comment 1 - Accountancy. The term accountancy unquestionably includes the types of financial and tax services provided by CPAs and very probably by Enrolled Agents. Whether it includes general bookkeeping services is unclear.
- Comment 2 - Health. Health under the service partner rule can be safely assumed to mean health within the meaning of Section 1.448-IT(e)(4)(ii) – namely, "the provision of medical services by physicians, nurses, dentists and other similar health professionals." Under the regulation just cited, it probably does not include the operation of health clubs. It is unclear whether it includes medical testing services and other medical services not traditionally thought of as those of medical professions. It is also unclear whether it includes veterinary services.
- Comment 3 - Consulting. Consulting under the service partner rule can be safely assumed to mean consulting within the meaning of Section 1.448-IT(e)(4)(iv) – namely, "the provision of advice and counsel."

- Comment 4 - Engineering. Engineering under the service partner rule can be safely assumed to include mapping and surveying within the meaning of Section 1.448-1T(e)(4)(i)(C).

2) The questionable reasonableness of the test. For the following principal reasons, I believe that the service partner test is unreasonable and that, accordingly, in litigation of the SET liability of an LLC member, a court might well strike it down.

   a) The non-service source of much professional income. The income of many professionals in the above seven professions who practice as members of LLCs is attributable not only to their professional services but also and to a substantial degree to their investment in capital assets, to the work of their staff and sometimes to additional factors other than professional services as such. To the extent that the LLC income of these professionals is not attributable to their direct personal services, it should not be subject to SET.

      An obvious example of a profession to which the application of the service partner rule may be unfair and unreasonable is the medical specialization of radiology, A successful radiology practice is likely to require not only the skilled services of radiologists but also the services of several or even dozens of staff personnel and hundreds of thousands or even millions of dollars of capital investments.

   b) The inconsistency of the service partner rule with Subchapter S principles. The service partner rule subjects to SET income of members of professional LLCs who, if they were to conduct identical professional practices as members of LLCs or other entities taxable as S corporations, would be subject to FICA tax only on their reasonable compensation for their professional services.

IV. THE PROP. REG. SINGLE-CLASS-OF-INTEREST RULE AND TWO-CLASSES-OF-INTERESTS RULE

A. Introduction

The Prop. Reg. contains two rules – namely, the single-class-of-interest rule and the two-classes-of-interests rule—that can often be useful to LLC members in reducing or even eliminating SET liability on their LLC income even though these members fail one or more of the Four Tests and thus are not limited partners under the Prop. Reg. The two tests are discussed in, respectively, Parts IV.B and C of this memorandum. Parts IV.D through F discuss various issues that are often important in planning for SET avoidance under the two rules but that the Prop. Reg. does not clearly resolve.

B. Avoidance of SET on LLC income of LLC members who fail the 500-hour rule - the Prop. Reg. "single-class-of interest" rule

1) Introduction to the single-class-of-interest rule; the "substantiality" test; the 20% safe harbor test for substantiality. Under Section 1402(a)(13), an individual who was a member of a traditional limited partnership could, regardless of any services provided by the individual to the partnership, avoid SET on his or her distributive share of

partnership income to the extent that this income was in respect of the individual's limited partner interest.

Mirroring this traditional rule, Prop. Reg. §1.1402(a)-2(h)(4) provides that an individual (identified here, for concreteness, as "John Jones") (i) who is an LLC member, (ii) who holds an interest in only a single class of interest of the LLC,[8] and (iii) who fails to qualify as a limited partner under the Prop. Reg. solely because he fails the 500-hour test will nevertheless avoid SET on his income in respect of that class of interest if the class of interest meets a "substantiality test" – i.e., if "substantial, continuing" interests in it are held by one or more other members who *do* qualify as limited partners under the Prop. Reg. Prop. Reg. §1.1402(a)-2(h)(6)(i) provides a safe harbor rule under which interests held by the other holders of the above class of interest (the "Other Members") will be deemed to be substantial if these interests constitute at least 20% of the total interests in the class.

2) The IRS' rationale for the single-class-of-interest rule. The preamble of the Prop. Reg. states, in effect, that in the IRS's view, amounts earned by individuals such as Jones in respect of a class of interests that meets the substantiality test are "demonstrably returns on capital invested [by these individuals] in the partnership." The preamble does not explain this statement. However, the reasoning underlying it appears to be that since the above "Other Members" are receiving income in respect of the above class purely as passive investors, then Jones' income in respect of the class must also be presumed to be passive income and thus not subject to SET.

3) The restricted nature of the single-class-of-interest rule. By its terms, the single-class-of-interest rule cannot be useful to members of LLCs who have LLC contract authority; who are members of a service partnership; or who have elected to have personal liability for LLC debt. Rather, the rule is designed for the rather rare situation in which an individual who is not a manager of an LLC nevertheless devotes substantial time to the LLC's business or internal affairs. If such an individual were a limited partner of a traditional limited partnership, the individual would automatically avoid SET or his or her distributive share of limited partnership income. The single-class-of-interest rule affords the same opportunity to individuals who are LLC members.

4) Planning opportunities under the single-class-of-interest rule. For members of LLCs in which most or all members devote substantial time to the LLC's business, the single-class-of-interest rule may provide a far simpler means of avoiding SET on LLC income than the two-classes-of-interests rule. To illustrate:

[8] Under Prop. Reg. §1.1402(a)-2(h)(6)(i), a class of interest is "an interest that grants the holder specific rights and obligations." The fourth sentence of Prop. Reg. §1.1402(a)-2(h)(6)(i) provides, in effect, that the right to receive a guaranteed payment from an LLC does not constitute a separate class of interest.

Example – stock brokerage. Individuals A, B, C and D (the "Members") are stock brokers whose LLC (the "LLC") provides brokerage services. All of the members work full-time for the LLC. Under Treas. Regs. Section 1.448-1T(e)(iv) (which expressly provides that stock brokers are not consultants within the meaning of that regulation), the Members very probably are not service partners under Prop. Reg. §1.1402(a)-2(h)(5). If the Members are willing to restrict formal LLC contract authority to a non-member of the LLC – e.g., an LLC non-member administrative officer – and if they are willing to allow their spouses or other persons to invest in the LLC as purely passive members (and if applicable law and ethical rules so permit), then all of the Members may be able to avoid substantial SET by paying themselves modest guaranteed payments and treating ther remaining shares of their LLC income as distributive shares not subject to SET under the single-class-of-interest rule.

5) Evaluation of the single-class-of-interest rule. As discussed in Part VII of this memorandum, it is highly probably that the IRS will apply the single-class-of-interest rule in auditing the SET liability of LLC members who fail to qualify as limited partners under the Prop. Reg. solely because they fail the 500-hour test and that the courts will treat this rule as binding on the IRS. In my opinion, the rule is generally reasonable.

However, there are two issues that can often arise under both the single-class-of-interest rule and the two-classes-of-interests rule discussed below – namely, the "investment-need" and the "reasonable compensation" issue – that may importantly affect the reliability of these rules as means for avoiding SET. These issues are discussed in Parts II.H and I of this memorandum.

C. "Bifurcation" of their LLC income by LLC member-managers between SET income and non-SET income – the Prop. Reg. two-classes-of-interests rule

1) The two-classes-of-interests rule – introduction; content; rationale. Under Section 1402 as originally enacted, an individual could "bifurcate" his or her interest in a limited partnership. That is, the individual could simultaneously be a general partner of the partnership and thus a manager of it; and, by acquiring a limited partner interest, he or she could also be a passive investor in it. Under the first sentence of Section 1402(a)(1), such an individual would be liable for SET on his or her distributive share of partnership income as a general partner. However, under Section 1402(a)(13), the individual would not be liable for SET on his or her distributive share as a limited partner.

The Prop. Reg. provides for the above bifurcation under a rule – referred to here as the "two-classes-of-interests rule" – set forth in Prop. Reg. §1.1402(a)-2(h)(3). Under this rule, if an individual ("Mary Smith") who is a member of an LLC holds interests in at least two classes of LLC interests and fails to qualify as a limited partner under the Prop. Reg. because she fails any of the Four Tests, she will nevertheless owe no SET in respect of her income from any class in which she holds an interest that meets the above "substantiality" test.

As noted, the preamble to the Prop. Reg. states that the reason why amounts earned by Mary Smith in respect of an LLC class of interests that meets the "substantiality' test is that these amounts are "demonstrably returns on capital invested in the [partnership]."

2) Reasonableness of the two-classes-of-interests rule. In my view, a court would be likely to regard the two-classes-of-interests rule as a reasonable approach by the IRS in determining how Section 1402(a)(13) should be applied to LLC members and thus would treat the rule as binding both on the IRS itself and on LLC members.

3) Hypothetical example. A hypothetical example showing an implementation of the two-classes-of-interests rule is set forth in the attached Exhibit A.

D. When are LLC classes of interest that are held by two or more LLC members "identical" to one another for purposes of the single-class-of-interest and two-classes-of-interests rules?

As indicated, the Prop. Reg. provides that for purposes of both the single-class-of-interest rule and the two-classes-of-interests rule, an LLC member will be held to hold interests in the same class of interest as a class in which other members hold interests if the rights that these members have as holders of interests in that class and the obligations to which the members are subject as holders of interests in it are identical. Prop. Reg. §1.1402(a)-2(h)(3)(ii). The example provided in Prop. Reg. §1.1402(a)-2(h)(6) makes clear that even if members who have interests in a class of interest receive different amounts of income from it, their rights to income will be deemed to be identical as long as these rights are proportionate to the members' respective contributions in respect of the class.

However, there are two principal questions under the single-class-of-interest rule "identical class" requirement that the Prop. Reg. does not clearly resolve.

1) The interest-for-services issue. There is a question under the Prop. Reg. whether two members will be considered to hold interests in the same class of interests if one of them receives his or her interest in the class of interests in exchange for a contribution of cash or property and the other in exchange for past or future services.

   In my opinion, it would be reasonable to take the position that under the above circumstances, the classes of interests of the two members should be viewed as identical as long as the services in question are valued reasonably. However, the matter is not without doubt.

2) The entity-member issue. It is unclear whether two members will be considered to hold interests in the same class of interests if one of them is an individual and the other is an entity. See Prop. Reg. §1.1402(a)-2(h)(2), which arguably implies that only individuals may be limited partners within the meaning of the Prop. Reg.

   Again, while the matter is not without doubt, it is my opinion that one can reasonably assume that in the above circumstances, the classes of interest of the two members should be deemed to be identical under the Prop. Reg., since, presumably, the fact

that a partner of a traditional limited partnership was an entity under Section 1402(a)(13) would not have affected the applicability of that section.

E. The "need-for-investment" issue under the Prop. Reg.

1) Introduction

There are two key unresolved issues that tax professionals often must address in seeking to assist clients to take full advantage of the Prop. Reg. The two issues are closely related but conceptually distinct.

- The first issue is whether the single-class-of-interest rule or the two-classes-of-interests rule is available to LLCs that have no substantial need for capital (the "need-for-investment" issue).
- The second is whether, in order to comply with the spirit of these rules, LLCs must pay members "reasonable compensation," as determined by the applicable federal tax authorities under Subchapters C and S, for services that these members render to or for these LLCs (the "reasonable compensation" issue).

Both of these issues are best understood on the basis of concrete examples.

2) The "need-for-investment" issue

Example. John Jones has worked for years as an employee of a commercial real estate appraisal company and, in that capacity, has developed substantial skill as a real estate appraiser. He has decided to form his own real estate appraisal LLC (the "LLC"), for which he will be the sole appraiser. He will operate the LLC from a home office, and the LLC will need, at most, only $1,000 of start-up capital.

John's lawyer, in consultation with his accountant, forms the LLC as a manager-managed multi-member LLC and drafts the LLC's operating agreement to take advantage of the two-classes-of-interests rule under the Prop. Reg. The members of the LLC are John, who is also the LLC's sole manager, and his wife Jane, who is a non-manager member. The operating agreement provides for a manager class, of which John is the sole member, and an investor class, of which John and Jane are the members. John contributes $800 to the LLC in exchange for an 80 percent interest in the investor class. Jane contributes $200 for a 20% interest in that class.

At the end of 200X (the first year of its operation), after paying a guaranteed payment to John and a modest distributive share to him in respect of his sole ownership of the LLC's manager class, the LLC has net profits of $50,000. In accordance with its operating agreement, it allocates all of this $50,000 to its investor class and, in turn, allocates and distributes $40,000 to John and $10,000 to Jane in respect of the class.

An important question posed by the above example is whether, in determining John's SET liability for Year 200X, the IRS must respect the above allocations, or whether instead, because the LLC arguably did not need the above $5,000 investment and because Jane's return of $10,000 was manifestly excessive, the IRS may treat most or all of the above $50,000 as income of John subject to SET.

F. The "reasonable compensation" issue under the Prop. Reg.

EXAMPLE. Mary Roe is sole owner of XYZ, a convenience store of which she is the manager and for which she works 40 hours a week. XYZ also has three full-time employees. In Year 200X, XYZ has net income of $100,000, which Mary draws as her profit from operating XYZ.

Effective the first day of the following year, 200Y, Mary converts XYZ to a manager-managed two-member LLC (the "LLC"), of which she is the manager-member and her husband is a non-manager member. The articles of organization and operating agreement of the LLC comply fully with the Prop. Reg. two-classes-of-interests rule. At the end of Year 200Y, the LLC has net income of $100,000 before any payment of compensation to Mary. In accordance with the LLC's operating agreement, Mary pays herself a guaranteed payment of $10,000, makes a small allocation and distribution to herself in respect of the LLC's manager class, and allocates and distributes all remaining income to herself and her husband in respect of the investor class. If Mary had hired a third party to manage the LLC and to work there for 40 hours a week, she would have paid this third party $30,000.

A key issue in the above example is whether the IRS may recharacterize any portion of Mary's distributive share of the LLC's income as reasonable compensation, and, on that basis, successfully assess an SET deficiency against Mary.

In my view, the answer to the above question is very probably no. Among other considerations:

1) The Prop. Reg. imposes no reasonable compensation requirement.
2) I have found no federal tax case nor other federal tax authority either holding or suggesting that the IRS may recharacterize as NEFSE a partner's distributive share of partnership income treated by the partner as exempt from SET under Section 1402(a)(13) or on any other ground.
3) The above recharacterization would arguably be inconsistent with the essentially contractual nature of partnership law. This law provides partners with substantial flexibility in determining, among other things, the extent to which their share of partnership income will be in the form of guaranteed payments and the extent to which it will be a limited partner's distributive share.

Nevertheless, I believe that in advising clients who seek to exploit the single-class-of-interest rule and the two-classes-of-interests rule, the less their LLC remunerates their services to or for it through guaranteed payments and distributive shares subject to SET, the greater will be their risk of an adverse SET audit.

In other words, in coming to grips with both the need-for-investment issue and the reasonable compensation issue under the Prop. Reg., there is wisdom in the well-worn tax cliché "pigs get fat but hogs get slaughtered."

G. The family attribution issue under the Prop. Reg.

For many clients who wish to maximize SET avoidance under the Prop. Reg. by conducting their businesses through manager-managed two-member LLCs, the best possible second member is their spouse. This is because, assuming reasonable marital stability, the two spouses form a continuing single economic unit and they are likely to be reasonably harmonious about LLC issues.

However, in deciding whether to suggest to a client to admit a spouse, children or other close relatives to an LLC to meet Prop. Reg. requirements, tax advisers must consider whether the LLC arrangements thus established may be challenged under any of the various attribution rules contained in the IRC.

In my opinion, the answer to this question is generally no. Among other considerations:

1) By their terms, none of these attribution rules applies to manager-managed multi-member LLCs of the kind required in order to take advantage of the Prop. Reg. single-class-of-interest rule and two-classes-of-interest rule.
2) The key issue with respect to the above LLCs is unlikely to be an attribution issue, but rather, the issue whether the newly admitted spouse or other relative is the true owner of the LLC membership rights in question. In my view, as long as the new member has paid valid consideration for his or her interest and has unrestricted ownership of these rights and reasonable protection from minority member oppression under the LLC's operating agreement, no challenge as to the reality of the membership will have a significant chance of success.[9]

V. CHOOSING BETWEEN SUBCHAPTER K AND SUBCHAPTER S TO MINIMIZE SOCIAL SECURITY TAX

A. Introduction

In order to avoid Social Security tax on their active income, individuals who are business owners and who also work for their businesses generally must use either Subchapter K or Subchapter S. In the following paragraphs, I will provide brief guidelines for choosing between these two subchapters for Social Security tax avoidance purposes. First, however, it will be useful (i) to briefly restate the Prop. Reg. rules governing the SET

[9] Finally, I should note that when the Prop. Reg. was first issued, I called Robert Honigman of the IRS Chief Counsel's Office and expressly asked him whether, in his view, any attribution rule was applicable under the Prop. Reg. He responded that the answer was no and that although the IRS had considered importing such a rule into the Prop. Reg., it had decided not to do so. This decision was perhaps due in part to the fact that in recent decades, the concept of a purely passive spousal accommodation member in an active business has become progressively less credible.

Thus, while my telephone conversation with Robert Honigman obviously is entitled to no evidentiary weight, it should provide at least a measure of additional comfort in arranging for spouses to be LLC co-members for purposes of exploiting the Prop. Reg. two-classes-of-interests rule.

liability of individuals who are members of LLCs taxable as partnerships; and (ii) to summarize the rules governing FICA tax avoidance by shareholders of S corporations who are also employees of these corporations.

B. Rules governing liability of LLC members for SET under the Prop. Reg. – brief summary

1) The four tests for determining whether an individual is a "limited partner." Individuals who are limited partners within the meaning of IRC Section 1402(a)(13) are not subject to SET on their distributive share of limited partnership income. Under the Prop. Reg., individuals who are members of LLCs taxable as partnerships are deemed to be limited partners under Section 1402(a)(13) if they meet each of the following four tests:

   a) Under the governing LLC act, they have no personal liability for LLC debt.

   b) Under the governing LLC act, they have no LLC contract authority.

   c) They work for 500 or fewer hours for their LLC in the relevant LLC taxable year.

   d) They are not "service partners."

2) The single-class-of-interest test. Individuals who fail to qualify as limited partners under the Prop. Reg. solely because they fail the above 500-hour test and who own an interest in only one class of interest in the LLC may nevertheless avoid SET on their income in respect of that class if one or more other members who are limited partners under the Prop. Reg. own a substantial portion of the interests in that class on a continuing basis.

3) The two-classes-of-interests test. Individuals who fail to qualify as limited partners under the Prop. Reg. because they fail any of the above four tests and who own interests in at least two classes of interests in the LLC may avoid SET on their income in respect of any such class if one or more other members who are limited partners under the Prop. Reg. own a substantial portion of the interests in that class on a continuing basis.

C. Rules governing FICA liability of S corporation shareholders who are employees of their corporations

Individuals who are both shareholders and employees of entities taxable as S corporations may avoid FICA taxes on their share of their corporation's net income if the corporation pays them reasonable compensation for services to and for their corporation. See, e.g., Rev. Rul. 59-221, 1959-1 C.B. 225; IRS Pub. No 533 (2205), Self-employment Tax; *Spicer Accounting Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); Rev Rul. 74-44, 1974-1 C.B. 287. For a useful current review of federal tax cases defining reasonable compensation, see Note, "What Is Reasonable Compensation for Deduction Purposes? Two Tests Exist but Neither Paints a Clear Picture," 57 Tax Lawyer 793 (2004).

D. Guidelines for use in choosing between Subchapter K and Subchapter S for owners of LLCs and other business entities

1) Individuals who own single-owner businesses can generally avoid Social Security tax only through the use of Subchapter S. In general, if an individual is the sole owner of

his or her business and does not want to have an additional owner or cannot identify a suitable additional owner, then the individual can avoid Social Security tax only by using Subchapter S.

   a) However, if the income of the entity is exempt from SET under Section 1402(a) as dividends, interest, capital gains or real estate rentals, then the fact that the individual has no co-owner will not trigger SET liability for the individual.

   b) In addition, individuals who own single-owner operating businesses that have significant business assets can sometimes avoid Social Security tax and also achieve substantial business asset protection by converting their operating businesses into rental businesses and renting their business assets to newly formed operating entities.

2) Avoidance of the complexities of the Prop. Reg. If an individual is an owner of a multi-owner entity and wants to avoid the complexities of the Prop. Reg., the owner can avoid Social Security tax only by using Subchapter S.

3) Risk of relying on single-class-of-interest rule or two-classes-of-interests rule in cases that have no significant need for investment capital. If an individual is an owner of a multi-owner entity and has entity contract authority but the entity does not need significant capital investment, then the individual's use of the Prop. Reg. single-class-of-interest or two-classes-of-interests rules to avoid Social Security tax probably will involve significant tax risk. For such an individual, Subchapter S may provide a safer means of avoiding Social Security tax.

4) Risk of relying on two-classes-of-interests rule where no significant guaranteed payment is paid. If an individual is an owner of a multi-owner entity and has entity contract authority and the entity pays the individual no guaranteed payment for his or her services to or for the LLC or only a very modest guaranteed payment, then, in general, the individual's use of the Prop. Reg. two-classes-of-interests rule may involve significant tax risk.

   a) However, if the entity in question is a rental entity and does not need significant services from its members, then its payment of a very modest guaranteed payment to its owners or event none at all may not create a Social Security tax risk.

E. Federal income tax factors in choosing between Subchapter K and Subchapter S as a means of avoiding Social Security tax.

Subchapter K provides certain federal income tax advantages that Subchapter S does not provide. Sometimes these advantages may be more important to a given individual than the benefit of avoiding Social Security tax. The principal federal income tax advantages of Subchapter K over Subchapter S are these:

1) Section 701. Under Section 701, owners of entities taxable as partnerships can obtain pass-through taxation without having to comply with eligibility rules or filing an election. Entities taxable under Subchapter S must comply with extensive statutory eligibility rules and must file an IRS Form 2553.

2) Section 704(a). Under Section 704(a), entities taxable as partnerships may (subject to certain exceptions) make allocations of their profits and losses and distributions of their profits in a manner that is disproportionate to owners' contributions. Entities taxable under Subchapter S must allocate their profits and losses and distribute their profits on a strict per-share/per-day basis.

3) Section 721(a). Under Section 721(a), contributions to entities taxable as partnerships are tax-deferred without regard to any Section 351(a) 80-percent control rule. Contributions to entities taxable as S corporations are tax-deferred only if they comply with this rule.

4) Section 731(a). Under Section 731(a), entities taxable as partnerships can (with certain exceptions) distribute their assets to partners on a tax-deferred basis. Distributions of assets by entities taxable as S corporations to their shareholders are treated for federal income tax purposes as deemed sales of these assets and generally trigger loss or gain to the shareholders.

5) Sections 734 and 743. Under Sections 734 and 743, sales and redemptions of interests of owners of entities taxable as partnerships generally result in stepped-up inside bases for the purchasers. No such rules apply in the case of entities taxable as S corporations.

6) Section 736. Under Section 736, owners of entities taxable as partnerships can sometimes obtain more favorable tax treatment in redemptions of their ownership interests than owners of S corporation stock.

7) Section 752. Under Section 752 and related federal tax authorities, owners of entities taxable as partnerships generally may include entity debt in their basis in their ownership interests. S corporation shareholders may include in their stock basis only amounts they have personally loaned to the corporation.

VI. IN THE ABSENCE OF FINAL GUIDANCE FROM THE IRS, HOW ARE CPAs ADVISING LLC MEMBERS ABOUT LLC SET ISSUES?

A. Introduction

Set forth below is my understanding, on the basis of information reasonably available to me from the CPA communities with which I am in contact, about the advice that CPAs are currently providing to their clients who are members of LLCs (i) as to whether these clients are subject to SET on their shares of LLC income; and (ii) how they may avoid SET on this income.[10]

As will be clear from the points below, there appears to be widespread ignorance among CPAs about the value and importance of the Prop. Reg. in determining the SET liability of individuals who are LLC members, and even CPAs who are generally aware of the Prop. Reg. appear to have little detailed practical understanding of it. I suspect that the main reason for the relative lack of awareness and understanding of the Prop. Reg. among many CPAs is the fact that the Prop. Reg. is merely a proposed regulation. Another reason may be the Prop. Reg.'s somewhat forbidding complexity.

B. Key points from my contacts with CPAs about LLC SET matters

1) Level of CPA awareness of the Prop. Reg. The greater the sophistication of a CPA firm in federal tax matters, the greater the likelihood that it will be familiar with the Prop. Reg. However, as indicated, a substantial portion even of sophisticated CPA firms appear to have little or no knowledge of the Prop. Reg., and among less sophisticated CPAs, unawareness of the Prop. Reg. appears to be widespread.

2) Level of CPA awareness of the "member management" factor in determining LLC members' SET liability. Even in sophisticated CPA firms, many CPAs are unaware of the fact that under the Prop. Reg., if an LLC taxable as a partnership is member-managed, all of its members, no matter how inactive in LLC matters, are subject to SET on their entire share of LLC income.

3) The belief of some CPAs that because the Prop. Reg. is merely proposed, it cannot be relied upon and that there is no reliable IRS guidance about the SET liability of LLC members. Many CPAs who are familiar with the Prop. Reg. believe that, precisely because it is merely *proposed*, it is not a reliable basis for advising their clients about LLC SET matters. Many of these CPAs also appear to believe that, as a practical matter, there is no existing IRS or other guidance on these matters and thus that, in advising their clients about these matters, they must use their best independent judgment.

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[10] The points above are based principally on inquiries I have made:

- With the two principal Internet discussion groups of which I am a member that are concerned with these issues – namely, LNET-LLC and ABA-TAX; and
- With roughly a dozen CPAs in New Hampshire and other jurisdictions with whom I have discussed the issues in telephone conversations.

4) Reliance of some CPAs on a "participation in decision-making" factor. Many CPAs appear to believe that the SET liability of the members of LLCs taxable as partnerships is determined by the degree of the members' participation in LLC decision-making, and these CPAs appear to be unaware that under the Prop. Reg., participation in decision-making is irrelevant to SET liability. Many of these CPAs appear to be unaware that even members who take no role whatsoever in LLC decision-making will be liable for SET on their shares of LLC income if their LLCs are member-managed.

5) Reliance of some CPAs on a "reasonable compensation" approach in protecting LLC members from SET liability. Some CPAs appear to believe that because there is no final IRS guidance about the SET liability of members of LLCs taxable as partnerships, the only safe way to protect members of these LLCs from Social Security Taxes is to have the LLCs make S elections and to have members pay FICA on their reasonable compensation for services to or for the LLC. Other CPAs appear to believe that in the absence of IRS guidance, they can safely rely on a "reasonable compensation" approach to protect LLC members from SET.

6) CPA unawareness of the "bona fide capital investment" and "reasonable compensation" issues under the Prop. Reg. None of the CPAs with whom I have been in contact appear to be aware that there are serious "need-for-investment" and "reasonable compensation" issues under the Prop. Reg.

7) CPA unawareness of various other issues under the Prop. Reg. None of the CPAs with whom I have been in contact appear to be aware that there are significant issues in:

   a) Interpreting the scope of the terms "accounting," "consulting," and "health" in the Prop. Reg.;

   b) Interpreting the meaning of the term "class of interest" in the Prop. Reg.; or

   c) Determining the validity of the service partner rule under the Prop. Reg.

8) CPA failure to distinguish various questions about the reliability of the Prop. Reg. No CPA with whom I have been in contact appears to have made a conscious distinction among the following questions:

   a) Whether the IRS is likely to use the Prop. Reg. in auditing the SET liability of members of LLCs taxable as partnerships;

   b) Whether, in tax litigation, the courts are likely to hold that the Prop. Reg. in its entirety is binding on the IRS;

   c) Whether, in tax litigation, the courts are likely to hold that the Prop. Reg. in its entirety is binding on LLC members;

   d) Whether, in tax litigation, the courts are likely to hold that some rules of the Prop. Reg. but not others are binding on LLC members; or

   e) Whether the binding effect of the Prop. Reg. is likely to vary depending on the specific Prop. Reg. issue in question.

VII. SINCE PROP. REG. §1.1402(a)-2 IS MERELY A PROPOSED REGULATION, TO WHAT EXTENT CAN LLC MEMBERS RELY ON IT IN PLANNING FOR SET AVOIDANCE?

A. Introduction

The Prop. Reg. is merely a proposed regulation. Numerous cases have held that, in general, proposed regulations are binding neither on the IRS nor on taxpayers. See, *e.g.*, *LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984) ("Proposed Regulations are [merely] suggestions made for comment . . . ."); see generally, Dembitzer, "Beyond the IRS Restructuring and Reform Act of 1998: Perceived Abuses of the Treasury Department's Rulemaking Authority," 52 Tax Lawyer 501 (Spring 1999).

In view of the above authorities, the tax advisers of individuals who are members of LLCs taxable as partnerships and who want to minimize their SET liability on their shares of LLC income must carefully consider the question of the extent to which these members can rely on the Prop. Reg. in their SET planning. In my opinion, this general question about the reliability of the Prop. Reg. can only be answered by addressing five subsidiary questions. Each of these questions is stated and briefly addressed below.

B. Can LLC members be confident that in auditing them for SET compliance, the IRS will use the Prop. Reg. as its audit guideline?

The answer to this question is clearly that the IRS will use the Prop. Reg. as its audit guideline on all issues clearly addressed in the Prop. Reg. and will not derive guidelines from any other source. Among other considerations:

1) The IRS's 2003 statement. On June 13, 2003, Lucy Clark, an IRS national issue specialist in the IRS's Examination Specialization Program stated as follows: "If [a] taxpayer conforms to the [Prop. Reg.], we generally will not challenge what they do or don't do with regard to Self-employment Taxes." Alison Bennett, "Taxpayers Can Rely on Proposed Regulations for LLC Self-employment Tax, Clark Says," 114 BNA's Daily Tax Report (Friday, June 13, 2003) Page G-3. While, in making her statement, Ms. Clark obviously was not voicing an official position of the IRS, it is unlikely that she would have made the statement unless she was confident when she did so that it reflected high-level IRS thinking; I am aware of no factor that has arisen since her statement that would change that thinking; and IRS managers with high-level authority must have known of her statement but did not seek to qualify it.

2) The drafting history of the Prop. Reg. In developing the Prop. Reg., the IRS acted with great care and deliberation, and the preamble of the Prop. Reg. in its final form reflects a detailed responsiveness of the IRS to public comments on the draft Prop. Reg. Furthermore, the Prop. Reg. reflects a radical and painstaking rethinking of predecessor proposed regulations on the same subject issued in 1994.[11] Accordingly,

[11] See Prop. Reg. §1.1402(a)-18, issued on December 29, 1994, and withdrawn on January 10, 1997 in connection with the issuance of the Prop. Reg.

the IRS undoubtedly views the Prop. Reg. as the best approach available to it in interpreting Section 1402(a)(13) in the absence of Congressional guidance and as an approach, therefore, which it ought to follow in SET audits.

3) The eight-year longevity of the Prop. Reg. If, after the above June 13, 2003 statement and after making no changes in the Prop. Reg. in the almost eight years since its publication, the IRS were to audit LLC members on their SET liability on any basis other than the Prop. Reg., it would be acting with serious unfairness and would thus probably be opening itself to a highly negative judicial response.

C. In litigation concerning LLC members' SET liabilities, are the courts likely to treat the Prop. Reg. as binding on the IRS?

It is my opinion that in view of the fact that during the past five years, the IRS has never withdrawn or modified the Prop. Reg. and in view of the above 2003 IRS statement, any court would probably hold that even though this regulation is merely proposed, it must be treated as binding on the IRS as to all issues that it addresses. See generally, *Elkins*, 81 T.C. 669 (1983).

D. In litigation concerning LLC members' SET liabilities, are the courts likely to treat the Prop. Reg. as binding on the members?

There is no case law nor other federal tax authority reasonably on point concerning the above question. Nevertheless, I believe that in litigation involving the SET liability of LLC members, the courts would determine the legal validity of each relevant Prop. Reg. on its own merits. However, I also believe that with regard to Prop. Reg. rules about whose validity the courts may be uncertain – e.g., the 500-hour rule and the single-class-of-interest and two-classes-of-interests rules – they will give significant deference to the IRS because of the obvious care with which the IRS has drafted these rules.[12],[13]

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[12] A final question concerning the status of the Prop. Reg. as federal tax authority is whether it constitutes substantial authority for purposes of avoiding the accuracy-related penalty under Section 6652. In general, proposed regulations constitute substantial authority under the Section 6652 regulations only for federal income tax purposes. In my view, however, a court would also be likely to give substantial weight to the Prop. Reg. in determining whether penalties should apply for nonpayment of Social Security Taxes.

[13] Recent Joint Committee proposal. On January 27, 2005, the Joint Committee on Taxation of the U. S. Congress published a report in which, among other things, it proposed to replace currently applicable law and regulations governing the Social Security tax liability of individuals who are partners of tax partnerships and S corporation shareholders. In essence, the new rules would provide as follows:

- The types of income exempted from Social Security tax under Section 1402 as currently in effect – e.g., interest, dividends, certain gains, and real estate rentals - would remain exempt. However, the exemption for limited partners' shares of limited partnership income would be repealed.
- As under the Prop. Reg., all of the income of such individuals who provide professional services would be subject to Social Security tax;
- All individuals who are partners of tax partnerships or shareholders of S corporations who do not materially participate in the trade or business of their partnership or S corporation will be subject to Social Security tax only under reasonable compensation standards.
- Finally – and most radically – all of the income of individuals who are partners of tax partnerships or shareholders of S corporations and who do materially participate in the businesses of their entities

EXHIBIT A

ILLUSTRATION OF BIFURCATION UNDER PROP. REG. § 1.1402(a)-2(h)(3) (THE "TWO-CLASSES-OF-INTERESTS RULE")

1) Formation of Doe Trucking, LLC. On January 1, 2002, John Doe, a trucker, and his wife Jane Doe, a teacher, form Doe Trucking, LLC (the "LLC"). The taxable year of the LLC is the calendar year.

2) Roles of John and Jane in the LLC. John will be the LLC's manager. Jane will be a non-manager member and will do the LLC's bookkeeping. Jane will work no more than 500 hours for the LLC during each of its taxable years.

3) Management structure of LLC under its articles of organization and operating agreement. The LLC's articles of organization and operating agreement (its "Operating Agreement") provide that the LLC is manager-managed, and the Operating Agreement appoints John as the sole manager.

4) Classes of interests under the Operating Agreement. The Operating Agreement provides for two classes of interests – a manager class and an investor class.

5) Allocations under the Operating Agreement. The Operating Agreement provides as follows about these classes of interests:

   a) The LLC must allocate the first $500 of its annual net income to the manager class.

   b) The LLC must allocate the balance of its annual net income to the investor class.

   c) Amounts allocated to the investor class must be allocated among the holders of interests in this class in proportion to their respective capital contribution in exchange for these interests.

   d) Distributions (except tax distributions) shall be at John's discretion.

6) Guaranteed payment to John. The Operating Agreement provides that as compensation for his management of the LLC in 2002, the LLC will pay John a

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would be subject to Social Security taxation. Thus, S corporation shareholders who materially participate in their corporation's business could no longer treat any portion of their respective shares of corporate income as dividends, and partners of tax partnerships who materially participate in their partnership's business could no longer "bifurcate" their income in accordance with the Prop. Reg.

It is impossible to predict at this time whether the above JCT proposal will ever be transformed into a bill or whether such a bill will ever pass. Even assuming, however, that such a bill is eventually written and passed, passage is unlikely to occur for some years. In the meantime, the Prop. Reg. remains the only reasonable basis available to LLC members for Social Security tax planning.

guaranteed payment of $25,000. (This amount is roughly comparable to what the LLC would pay to a third party for similar services.)

7) Contributions to the LLC. On January 1, 2002, the following individuals make the following contributions to the LLC:

CONTRIBUTOR	AMOUNT OF CONTRIBUTION	TYPE OF INTEREST ACQUIRED
John	$1,000	All units of manager class
John	$40,000	80 percent of units of investor class
Jane	$10,000	20 percent of units of investor class
TOTAL	$51,000	

8) Allocations and distributions for 2002. For calendar year 2002, the LLC earns net income of $125,000 before paying compensation to John. The LLC makes payments of compensation and allocations of profits and losses from its net income as set forth in the table below. It makes no distributions except tax distributions. Rather, all undistributed net income (except net income distributed as tax distributions) is retained and spent to grow the LLC.

RECIPIENT	AMOUNT	NATURE
John	$25,000	Guaranteed payment
John	$500	Allocation in respect of manager units
John	$80,000	Allocation in respect of investor units
Jane	$20,000	Allocation in respect of investor units

9) Tax consequences of above guaranteed payment and allocations.

   a) John pays federal income tax and Self-employment Tax on his guaranteed payment under Section 1402(a) (first sentence) because it is active income – i.e., income from the rendering of services.

   b) John pays federal income tax and Self-employment Tax under Section 1402(a) (first sentence) on his allocation in respect of his units of the manager class because there are no 20-percent passive owners of units in this class.

   c) Both John and Jane pay federal income tax on the above allocations in respect of the investor class. However, because Jane is a limited partner under the Prop. Reg. and owns 20 percent of the units of the investor class, neither Jane nor John pay Self-employment Tax on their allocations of profits from this class under Section 1402(a)(13); Prop. Reg. §1.1402(a)-2(h)(3).