Active LLC Members Try to Avoid SE Tax

Mr. Castigliola, Mr. Banahan, and Mr. Mullen are attorneys in Mississippi. Originally they practiced law as a general partnership but later reorganized their law firm as a professional limited liability company – Bryan, Nelson, Schroeder, Castigliola & Banahan, PLLC. During the years at question they practiced law only through this LLC. The LLC has never had a written operating agreement. The LLC timely filed partnership tax returns, Form 1065.

For the years 2008, 2009, and 2010, the members' compensation agreement required guaranteed payments to each member. The amount was based on local legal salaries as determined by a survey of legal salaries in the area. The net profits were distributed to the members in according with their agreement.

The tax returns for the LLC and the three petitioners in this case were prepared by the same CPA. The CPA had held several positions in the National Association of State Boards of Accountancy, including a three-year term on its board of directors. He also served eight years with the Alabama State Bar of Accountancy. He had prepared the law firm's partnership returns before it became a PLLC. When the attorneys formed the PLLC they met with the CPA for advice on reporting payments from the PLLC to the members.

Based on this advice the PLLC members reported their guaranteed payments as SE income but did not report their net profits as SE income. IRS assessed SE taxes on both the guaranteed payments and the distribute share of the net profits.

The attorneys argued they did not have to pay SE taxes on the net profits based on IRC Section 1402(a)(13) which states, in part: "There shall be excluded [from self-employment taxes] the distribute 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 it the nature of remuneration for those services***." IRS argued that the members were not limited partners for this purpose and therefore this exclusion did not apply.

Tax Court has previously noted that the term "limited partner" is not defined in statutes and therefore the Court applies accepted principals of statutory construction to ascertain congressional intent. In its discussion, the Court stated a limited partnership has two classes of partners, general and limited. General partners typically have management power and unlimited personal liability. On the other hand limited partners typically lack management power but enjoy immunity from liability for debts of the partnership.

Also the exact term of "limited partner" may vary slightly from state to state. Mississippi adopted the Revised Uniform Limited Partnership Act (1976) with some modifications. Section 7 of the RULPA (1976), states "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."

This PLLC was member-managed. This means management power over the business of the PLLC was vested in each of the members through the interest each held. There was no written operating agreement, nor was there any evidence that any member's management power was limited in any way. Further all members participated in control of the PLLC such as making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. As such they could not be limited partners. The members also testified that all members participated equally in all decisions and had substantially identical relationships with the PLLC. They also stated their activities were the same as they were when the law firm was a general partnership before its reformation as a PLLC. The Court therefore determined they must all have positions analogous to those of general partners.

Court's summary – the members of this PLLC are considered member-managers and are subject to SE taxes on their guaranteed payments as well as their distributive share of the net income. IRS had also assessed the Section 6662(a) accuracy related penalty. Tax Court denied this penalty, feeling the taxpayers had relied on the advice of a well qualified tax professional.

Vincent & Marie Castigliola, ETAL, TC Memo 2017-62, April 12, 2017