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Tax Tips

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Are LLC members subject to self-employment tax?

Ambiguity in the tax code and regulations has led many limited liability company (LLC) members to take an aggressive position regarding self-employment (SE) tax. They claim that their distributive shares of LLC income — after deducting compensation for services in the form of guaranteed payments — aren't subject to the tax.

Recently, however, the IRS has been cracking down on LLC members it claims have underreported SE taxes, seeking back taxes and penalties, with some success in court. Considering these developments, it's a good idea for LLC members to review their treatment of SE tax. (For the purposes of this article, LLCs also refer to limited liability partnerships and professional limited liability companies.)

SE tax refresher

The SE tax is designed to ensure that self-employed individuals pay the Social Security and Medicare taxes (payroll taxes) that would otherwise be withheld by an employer. Generally, employer and employee each pay a 6.2% Social Security tax on wages up to a wage base ($128,400 in 2018) and a 1.45% Medicare tax on all wages. Thus, self-employment income is subject to a 12.4% Social Security tax (up to the wage base) and a 2.9% Medicare tax. The "employer half" is deductible as a business expense.

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Generally, you're considered self-employed if you conduct a trade or business as a sole proprietor or you're a member of a partnership (including an LLC taxed as a partnership) that conducts a trade or business. General partners pay SE tax on all their business income from the partnership, whether it's distributed or not.

Limited partners are treated differently. Under the tax code, they're subject to SE tax on guaranteed payments for services they provide to the partnership. But they're otherwise exempt from SE taxes on their distributive shares of partnership income. The rationale for this provision is that limited partners, who have no management authority, are more akin to passive investors than active business participants.

S corporation shareholders who perform services for the business are subject to payroll taxes on their salaries. But so long as their compensation is reasonable, they escape SE tax on their distributive shares.

The LLC conundrum

Why all the confusion about the treatment of LLCs? Internal Revenue Code Section 1402(a)(13) was added to the tax code before the advent of the LLC. (The first LLC statute was enacted in 1977.) As the LLC form caught on, many LLC members took the position that they were equivalent to limited partners and, therefore, exempt from SE tax (except on guaranteed payments for services). But there's a big difference between limited partners and LLC members. Both enjoy limited personal liability, but, unlike limited partners, LLC members can actively participate in management without jeopardizing their liability protection.

Arguably, LLC members who are active in management or perform substantial services related to the LLC's business are subject to SE tax, while those who more closely resemble passive investors should be treated like limited partners. Unfortunately, guidance on this subject has been scarce. The IRS issued proposed regulations in 1997, but to this day hasn't finalized them (although it follows them as a matter of internal policy).

Under the proposed regulations, an LLC member's distributive share is exempt from SE tax *unless* the member:

- Is personally liable for the LLC's debts,
- Has authority to contract for the LLC, *or*
- Participates in the LLC's business for more than 500 hours per year.

There's a special rule, however, for "service partners" in service partnerships, such as law and accounting firms, medical practices, and architecture and engineering firms. Generally, they may not claim limited partner status regardless of their level of participation.

Some LLC members have argued that the IRS's failure to finalize the regulations supports the claim that their distributive shares aren't subject to SE tax. But the IRS routinely rejects this argument and, in recent years, has successfully litigated its position. The courts have imposed SE tax on LLC members unless, like traditional limited partners, they lack management authority and don't provide significant services to the business. And some courts have ruled that mere management *control*, by itself, is enough to defeat limited partner status, regardless of whether that control is exercised.

Capital matters

The IRS has taken the position that limited liability company (LLC) members who participate in management or provide significant services are subject to self-employment (SE) tax on their distributive shares, even if a substantial portion of that income is attributable to returns on invested capital. It's uncertain, however, how this approach would be greeted in the courts.

Proposed regulations contemplate situations in which an active LLC member can exclude amounts from self-employment income that are "demonstrably returns on capital invested in the partnership." For example, they provide that under certain circumstances LLC members may be able to segregate SE income from investment income by holding separate management and investor classes of interests, much like general partners can also hold limited partnership interests.

Review your options

The law in this area remains uncertain, particularly with regard to capital-intensive businesses. (See "Capital matters" above.) But given the IRS's aggressiveness in collecting SE taxes from LLCs, LLC members should review their treatment of SE taxes. Those who wish to avoid or reduce these taxes may have some options, including converting to an S corporation or limited partnership, or restructuring their ownership interests. When evaluating these strategies, bear in mind that there are other issues to consider besides taxes. ■

Ease new itemized deduction limitations using a nongrantor trust

Record-high exemption amounts mean that fewer families are affected by gift, estate and generation-skipping transfer (GST) taxes. As a result, the estate planning focus for many people has shifted from transfer taxes to income taxes. One tool that can be effective in reducing income taxes is a nongrantor trust, which offers a way around the new itemized deduction limitations imposed by the Tax Cuts and Jobs Act (TCJA).

What's a nongrantor trust?

A nongrantor trust is simply a trust that's a separate taxable entity. The trust owns the assets it holds and is responsible for taxes on any income those assets generate. A grantor trust, in contrast, is one in which the grantor retains certain powers and, therefore, is treated as the owner for income tax purposes.

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Both grantor and nongrantor trusts can be structured so that contributions are considered "completed gifts" for transfer tax purposes (thereby removing contributed assets from the grantor's taxable estate). But traditionally, grantor trusts have been the estate planning tool of choice. Why? It's because the trust's income is taxed to the grantor, reducing the size of the grantor's estate and allowing the trust assets to grow tax-free, leaving more wealth for beneficiaries. Essentially, the grantor's tax payments serve as an additional tax-free gift.

With less emphasis today on gift and estate tax savings, nongrantor trusts offer some significant benefits.

How can nongrantor trusts reduce income taxes?

The TCJA places new limits on itemized deductions, but nongrantor trusts may offer a way to avoid those limitations. The tax law nearly doubles the standard deduction to $12,000 for individuals and $24,000 for married couples and limits deductions for state and local taxes (SALT) to $10,000. These changes reduce or eliminate the benefits of itemized deductions for many taxpayers, especially those in high-SALT states. By placing assets in nongrantor trusts, it may be possible to increase

your deductions because each trust enjoys its own $10,000 SALT deduction.

For example, Andy and Kate, a married couple filing jointly, pay well over $10,000 per year in state income taxes. They also own two homes, each of which generates $20,000 per year in property taxes. Under the TCJA, the couple's SALT deduction is limited to $10,000, which covers a portion of their state income taxes, but they receive no tax benefit for the $40,000 they pay in property taxes. To avoid this limitation, they transfer the two homes to an LLC, together with assets that earn approximately $40,000 per year in income. Next, they give 25% LLC interests to four nongrantor trusts. Each trust earns around $10,000 per year, which is offset by its $10,000 property tax deduction. Essentially, this strategy allows the couple to deduct their entire $40,000 property tax bill.

Watch out for multiple trust rule

If you're contemplating using this strategy, be aware that the tax code contains a provision that treats multiple trusts with substantially the same grantors and beneficiaries as a single trust if their purpose is tax avoidance. Many experts believe that this provision is ineffective because the IRS has never issued implementing regulations.

To ensure that the rule doesn't erase the benefits of the nongrantor trust strategy, however, it may be a good idea to designate a different beneficiary for each trust. Contact your estate tax advisor for more information on nongrantor trusts. ■

Know your tax obligations before hiring household help

There are several reasons for hiring household help, including child or elder care or general cleaning and yard maintenance. However, when you hire outside help, you become an employer. Thus, you have specific tax obligations, such as withholding and paying Social Security and Medicare (FICA) taxes and possibly federal and state unemployment insurance. So before making the hire, it's important to understand your tax obligations, as well as the penalties for not meeting them.

Tax-related responsibilities

In general, if you pay a household worker at least $2,100 in 2018, you also must pay Social Security taxes of 6.2% on cash wages of up to $128,400 (in 2018), as well as a Medicare tax of 1.45% on all cash wages. "Cash wages" refers to compensation paid by, for instance, check or money order — but doesn't include the value of food, lodging or other noncash compensation.

You're also responsible for submitting the employee's share of Social Security (also 6.2%) and Medicare (also 1.45%) taxes. If you cover the employee's share yourself (adding up to 7.65%), you'll need to include that amount as wages for income tax purposes, but not for reporting Social Security and Medicare.

If you pay an employee $1,000 in any calendar quarter, you also may owe federal unemployment (FUTA) tax. This is 6% of the first $7,000 of cash wages per employee — up to $420 of tax each year — though this amount may be offset

by a credit. Some states also impose their own unemployment tax.

Keep accurate records

You'll need to record the names, addresses, Social Security numbers, and cash and noncash wages paid to household employees, as well as taxes withheld or paid, and retain this information for at least four years after the due date of the tax return on which the taxes were reported. In addition, you must obtain an Employer Identification Number, or EIN.

By January 31 of each year, you'll need to provide your employees with IRS Form W-2 ("Wage and Tax Statement") for the previous year. You also must file a copy with the Social Security Administration.

You'll have to file Schedule H, "Household Employment Taxes." After calculating the total amount of Social Security, Medicare, FUTA and withheld federal income tax, you'll add this to your income tax liability for the year.

To avoid having to pay household employee taxes when you file your return, you can make estimated payments throughout the year. Or, if you're employed, you can ask your employer to increase the amount of federal income tax withheld.

Exceptions to the rules

These tax and reporting obligations don't apply in the following situations, even if the employee's annual wages total more than $2,100:

- The employee is under age 18 (unless household employment is his or her primary occupation).
- The employee is your spouse.
- The employee is your child and under age 21.
- The employee is your parent — though some exceptions apply that might cause the wages to be included.

Using an independent contractor also can relieve you of some tax and reporting obligations — but the individual must be a bona fide independent contractor. The distinction between employee and contractor hinges on several factors, including how much control the worker has over the work done, and whether he or she offers services to the general public.

Turn to your advisor

If you're considering hiring outside household help, it's critical to understand your tax obligations. To avoid penalties due to missteps, consult with your tax advisor. ■

Yes, home equity loan interest may still be deductible

The Tax Cuts and Jobs Act (TCJA) imposes new limits on the deductibility of home mortgage interest, but, contrary to popular belief, interest on home equity loans (including home equity lines of credit and "second mortgages") is still deductible in many cases. The act suspends the deduction for home equity interest from 2018 through 2025, *unless* the loan is used to buy, build or substantially improve your main home or a qualifying second home.

Under prior law, you could deduct interest on up to $1 million in acquisition debt — that is, mortgage debt used to buy, build or substantially improve a first or second residence — plus up to $100,000 in home equity debt, defined as mortgage debt used for any other purpose, such as buying a boat or paying off credit cards. The TCJA lowers the acquisition debt limit to $750,000 (except for mortgages that predate the act) and eliminates the deduction for home equity interest until 2026.

You can still deduct interest on a loan characterized as a home equity loan, however, provided it meets the definition of "acquisition debt." So, for example, if you use a home equity loan to build an addition to your home, you can deduct the interest — subject to the $750,000 limit on combined acquisition debt on your first and second residences. Interest on home equity loans used for other purposes is not currently deductible. ■

Tax reform's impact on business losses

The Tax Cuts and Jobs Act (TCJA) made two significant changes that affect the deductibility of business losses. Previously, businesses could deduct net operating losses (NOLs) in full against the current year's income, with the excess carried back two years and carried forward up to 20 years. Beginning this year, the carryback period is eliminated and NOLs may be used only to offset up to 80% of current-year income. NOLs may now be carried forward indefinitely, however.

The TCJA also limits business losses for noncorporate taxpayers, including partners and S corporation shareholders. Under prior law, taxpayers could fully deduct losses so long as they had sufficient basis in the business and met certain other requirements. Under the TCJA, deductions for net business losses passed through to individuals are limited to $250,000 ($500,000 for joint filers). Excess losses are included in the taxpayer's NOLs and carried forward to subsequent years. ■

Is it time to revisit your QPRT?

If you transferred your home to a qualified personal residence trust (QPRT) years ago, the estate tax savings you envisioned may not be relevant today. If estate taxes are no longer a concern, talk to your tax advisor about unwinding the QPRT. One possible option is to continue living in the home rent-free after the trust term. This would pull the home back into your estate, entitling it to a stepped-up basis and relieving your heirs from capital gains taxes on the home's appreciation. ■

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