Are You An Owner Or Employee? The Inflexibility of the Federal Tax Rules To Be Treated As Both.

Over the last twenty years or so, the limited liability company ("LLC") has become a popular entity choice as a business entity. An LLC offers a great deal of flexibility in how it is structured and operates, including the ability for its owners to decide to be classified as a partnership, S corporation, C corporation or, if there is only one owner, to be disregarded as an entity for federal income tax purposes.

Notwithstanding the great deal of flexibility afforded to LLCs, the federal tax rules do not permit a person to be treated as both an owner and an employee of a LLC that is treated as a partnership or a disregarded entity. As a result, owners of these types LLCs who are employees of the LLC should be aware of how both their salary and income are treated for federal income tax purposes.

In the absence of a tax classification to the contrary, an LLC with more than one member will be classified as a partnership. In general, any income of the LLC
allocated to an owner who is also an employee will be subject to both income tax and the self-employment tax on such income.

The self-employment tax replaces the social security and Medicare tax paid by employees. In addition, the self-employment tax also includes the employer’s portion of these taxes since a self-employed person is an owner. While there are income deductions for a portion of the self-employment tax, it can be more burdensome for the owner than if he or she was merely an employee. Further, the self-employment tax is accessed on all of the income allocated to the owner and not just the part of the income that represents a reasonable salary. In general, the “salary” of an owner is treated as a “guaranteed payment” on the owner’s annual Schedule K-1 and can be subject to tax regardless of whether the LLC is profitable for the current year.

Under proposed regulations, a minority owner in certain LLCs may be able to exempt income from the self-employment tax other than the portion of such owner’s guaranteed payments provided such owner does not: (1) have personal liability for the debts or obligations of the LLC by reason of being a member; (2) had authority to enter into contracts on behalf of the member; or (3) participated in the LLC’s trade or business more than 500 hours annually (although there are exceptions to this 500 hour requirement). However, these rules do not apply to owners in professional service businesses involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting. Since these rules are only in proposed form, anyone who wants to rely on these proposed regulations should consult with their tax advisor.

Another issue for owners in an LLC is that the LLC generally does not withhold on any payments to the owners who are U.S. persons even the amounts made to the owners as salary. As a result, the owners are responsible for making quarterly estimated tax payments. For new owners, this can be an unexpected burden.

Owners of single member LLCs that are treated as disregarded entities have similar issues. All of the income recognized by the LLC is treated as the owner’s income from a sole proprietorship. As a result, all of the income of the LLC is generally subject to both income tax and the self-employment tax the same as an LLC treated as a partnership as discussed above. The owner is also subject to making quarterly estimated tax payments.

It is not uncommon for owners in LLCs to engage in tax planning to avoid some of these issues including creating employee leasing companies, a management company or establishing a multi-tiered partnership structure. These alternative structures can be complex and may be more costly than the issues they are trying to solve. LLCs can also elect to be treated as an S corporation or C corporation. However, electing to be these types of entities eliminates some of the advantages of being an LLC like a single layer of tax or avoiding some of the restrictive S corporation rules including the single class of stock rule and the limitation on shareholders who are individuals and U.S. persons.

An LLC that is treated as a partnership or disregarded entity for federal income tax purposes can still be the right choice of entity despite the issues discussed above and can offer many benefits. However, owners who are employees should be aware
of the different federal income tax treatment to them as an owner to avoid any unpleasant surprises.

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