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RECENT DEVELOPMENTS WITH LLCS: LIABILITY FOR SE TAX

— by Neil E. Harl*

Legislation authorizing the limited liability company (or LLC)[1] has been adopted in all but a few states despite the fact that, until recently, the Internal Revenue Service had provided relatively little guidance on LLCs and the concept had not been the subject of a uniform or model act. The IRS attention had been focused heavily on whether, under the various state statutes, LLCs were likely to be treated as partnerships for federal income tax purposes.[2]

In recent weeks, the Internal Revenue Service has provided substantially more guidance on the taxation of LLCs in the form of proposed regulations[3] and a revenue procedure.[4] These two developments, coupled with the resolution in most of the states with corporate limitations on farmland ownership and farm operation of the question of whether LLCs must comply with those limitations, should encourage greater use of the LLC.

Self-employment tax

A major concern with LLCs has been whether a member's share of the LLC's income is subject to self employment tax.[5] In general, a partner's share of income from a general partnership carrying on a trade or business is subject to self-employment tax.[6] However, the distributive share of income or loss from a limited partnership is excluded from self-employment tax except for guaranteed payments.[7] There has been no statutory guidance on whether members of an LLC are to be treated as general partners, as limited partners or as corporate shareholders.[8]

The Department of the Treasury has now published proposed regulations providing some clarification of the situation.[9]

Under the new proposed regulations, in general, an LLC member's net earnings from self-employment include the member's distributive share (whether or not distributed) of income or loss from any trade or business carried on by an LLC.[10] However, a member of an LLC is treated as a limited partner if the member is not a manager and the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction and the members could have qualified as a limited partner in that limited partnership.[11] This provision means that professional firms operating as LLCs (and others excluded from eligibility to operate as limited partnerships under state law) cannot take advantage of the new regulations.

If a member of an LLC is treated as a limited partner for purposes of self-employment tax liability, the member's distributive share of income or loss from the LLC is not included in net earnings from self-employment, except for guaranteed payments for services.[12]

In the event an LLC has no designated or elected managers who have continuing exclusive authority to manage the LLC, *all members are treated as managers* even if some members have greater management authority than others under state law or the governing document.[13]

This point suggests that immediate attention should be given to whether members in LLCs should act to designate one or more managers to shield the more inactive members from self-employment tax if that is the desired outcome. Keep in mind that —

- In general, LLC members *who are not designated as managers* are not subject to self-employment tax if one or more members have been designated as managers.
- If no managers have been designated, *all* members are subject to self-employment tax.

Warning on cash accounting

It is important to remember that a farm or ranch LLC with inactive members runs the risk of being classified as a farming syndicate.[14] Such a classification could cost the LLC the use of cash accounting.[15]

FOOTNOTES

1 See generally 8 Harl, *Agricultural Law* § 61.03 (1995); Harl, *Agricultural Law Manual* § 7.04[2][c](1995). See also N. Harl, "Limited Liability Companies," 4 *Agric. L. Dig.* 93 (1993); N. Harl, "Limited Liability Companies: Income Tax Treatment," 4 *Agric. L. Dig.* 101 (1993); N. Harl, "Limited Liability Companies: Eligibility for Cash Accounting," 4 *Agric. L. Dig.* 109 (1993).

2 E.g., Rev. Rul. 94-79, I.R.B. 1994-51, 7(Connecticut law).

3 Prop. Treas. Reg. § 1.1402(a)-18.

4 Rev. Proc. 95-10, I.R.B. 1995-3.

5 I.R.C. §§ 1401, 1402(a).

6 I.R.C. § 1402(a).

7 I.R.C. §§ 1402(a)(13), 707(c).

8 See I.R.C. § 1402(a).

9 Prop. Treas. Reg. § 1.1402(a)-18. See amendments proposed to Treas. Reg. §§ 1.1402(a)-1-1.1402(a)-3,

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published in the Federal Register on December 29, 1994. See also Ltr. Rul. 9452024, Sept. 29, 1994 (income allocated to each LLC member is included in that member's self-employment income when the member "engage[s] in the daily activities [of the firm] and will perform substantial services...").

[10] Prop. Treas. Reg. § 1.1402(a)-18.

[11] *Id*.

[12] *Id*.

[13] *Id*.

[14] I.R.C. § 464. See Prop. Treas. Reg. § 1.464-2(a)(1).

[15] I.R.C. § 464. See N. Harl, "Limited Liability Companies: Eligibility for Cash Accounting," 4 *Agric. L. Dig*. 109 (1993). See Harl, *Agricultural Law Manual* § 7.04 [2][c][i][A](1995).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

POSSESSION. When the plaintiffs purchased their property neighboring the defendant's, a fence existed on their property 30 feet on to the plaintiffs' property. The plaintiffs testified that when the property was purchased, the disputed strip was considered to be part of the plaintiffs' property; however, the plaintiffs did not attempt to have the fence moved and did not have a survey performed until eight years after the purchase. The defendant claimed title to the disputed land by over 30 years adverse possession. The defendant had farmed as close to the fence as possible, grazed cattle on the property, maintained a hog pen on the property and hunted on the property. The defendant and predecessor in title had helped maintain the fence and the defendant had grazed some cattle, hunted and rode horses on the disputed property. The court held that although the plaintiffs demonstrated some use of the disputed property during the 30 years, the trial court's ruling that the defendant had adversely possessed the disputed strip was not clearly wrong and was entitled to be affirmed. **Soileau v. Matte, 647 So.2d 617 (La. Ct. App. 1994)**.

BANKRUPTCY

CHAPTER 12-*ALM* § 13.03[8].*

DISMISSAL. After the debtors failed to obtain a modification of their Chapter 12 plan, the debtors filed to dismiss their case. A creditor, however, moved to convert the case to Chapter 7 because of fraud committed by the debtor during the bankruptcy case. The debtors argued that Section 1208(b) provided a mandatory dismissal of the case upon the debtors' request. The bank argued that Section 1208(d) took precedence if fraud by the debtor was shown. The court held that Section 1208(b) had precedence but ordered the dismissal to be held in abeyance in order for the creditor to prove the alleged fraud and for the court to order sanctions against the debtors before granting the dismissal. ***In re* Davenport, 175 B.R. 355 (Bankr. E.D. Calif. 1994)**.

ELIGIBILITY. The debtor formed a partnership with another person to operate a farm which bred and raised American Alpine show goats. The partnership agreement provided for a $15,000 annual guaranteed payment to the debtor for managing the operation. The debtor also worked part-time as a liquor store sales clerk. For the taxable year preceding the Chapter 12 bankruptcy petition, the debtor's income tax returns showed $15,000 in income from the partnership and $13,500 as the debtor's share of partnership losses. The partnership had total losses of $38,000 for that year and the other partner contributed $36,000 to help cover those losses. A creditor argued that the other partner's contribution was a gift to the debtor and not farm income; therefore, the debtor's nonfarm income exceeded farm income and the debtor was not eligible for Chapter 12. The court held that the debtor did perform management and breeding services for the partnership business and the partnership guaranteed payments were bona fide payments for services rendered; therefore, the guaranteed payments were farm income for purposes of Chapter 12 eligibility. ***In re* Pierce, 175 B.R. 153 (Bankr. D. Conn. 1994)**.

CHAPTER 13-*ALM* § 13.03.*

DISMISSAL. The debtors filed for Chapter 7 in July 1994 because the debtors were ineligible for Chapter 13 because of too much debt. After the Bankruptcy Reform Act of 1994 was passed which increased the debt amount for Chapter 13 filers, the debtors filed for conversion of their case or dismissal in order to refile under Chapter 13. The court held that the Act specifically prohibited retroactive application of the eligibility requirements and held that dismissal would not be allowed because refiling would give the debtors an advantage over the only creditor in the case. ***In re* Fitzpatrick, 175 B.R. 436 (Bankr. D. N.H. 1994)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

ABANDONMENT. The Chapter 7 debtor's creditors held claims secured by most of the debtor's farm property. The debtor and one of the secured creditors agreed to give the creditor relief from the automatic stay to sell livestock subject to a quarantine and the animals were sold with the proceeds applied to the secured claim. The trustee filed a Report of No Distribution and Notice of Intended Abandonment (the Notice) but did not obtain an abandonment order. With the consent of the trustee, the secured creditors obtained additional relief from the automatic stay to sell crops and machinery collateral for their claims. The crops were sold prior to the discharge of the debtor but the machinery was not sold until after the discharge. The agreement for the relief from the automatic stay contained a provision that any proceeds from the sales in excess of the claim were to be paid to the trustee. After the case was closed, the IRS sought payment from the debtor of taxes incurred by the gain on the sales of the animals, crops and machinery. The trustee argued that the assets were either abandoned by reason of the Notice or by