

CALIFORNIA LIMITED LIABILITY COMPANY REVIEW

LLC MEMBERS: PARTNERS OR EMPLOYEES

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The IRS has held for many years that a partner of a partnership for federal income tax purposes is not taxed as an employee for employment tax purposes. Accordingly, a key employee of a limited liability company (LLC) who obtains a membership interest in the LLC no longer is to receive a W-2 for amounts paid for services rendered to the LLC. (Rev. Rul. 69-184.) Instead, upon becoming a partner, the "key employee" is to receive a guaranteed payment, draw, distributive share, K-1 and otherwise have provisions apply to him or her that apply to partners. Primary differences are potential "above the line" deductions of unreimbursable expenses incurred by the partner related to the business of the partnership, self-employment taxes rather than FICA, estimated tax payments rather than wage withholding and in certain fringe benefits.

The "partner" treatment begs the question of whether the "key employee" obtains sufficient rights in the LLC to be treated as a partner for income tax purposes. For example, does an "income" partner have sufficient rights in the partnership to be taxed as a partner? If "partner"

treatment is desired, operating agreements should provide sufficient management and economic rights to those persons to support it.

The IRS knows about the disparate treatment between a "key employee" receiving stock in a corporation versus receiving a membership interest in an LLC and perhaps its potential "tax gap" abuse. In the former instance, the employment status of the "key employee" remains unchanged. However, at a seminar on May 22, 2012, the IRS reconfirmed that it is not currently pursuing changes to its longstanding position and legislation announced in this general area has focused on the tax treatment of "carried interests" of service partners and the self-employment taxes of S corporation shareholders.

On the other hand, the California Employment Development Department (EDD) has established different treatment for LLC members as explained on its Form DE 231 (LLC). Until 2011, the EDD generally treated as an employee under common law principles a member that was not a manager. In 2011, legislation attempted to

remove this disparity from federal treatment by adding a Section 623 to the California Unemployment Insurance Code that expressly treats a member of an LLC taxed as partnership as other than an employee. Unfortunately, the EDD has taken the position in its most recent version of Form DE 231 (LLC) that the statutory change applies only for unemployment, training and SDI taxes and not to wage withholding – so California may treat an LLC member as an employee for some employment tax purposes and as a partner for others. The EDD reaches that conclusion because the legislation did not duplicate the new provision in the portion of the Unemployment Insurance Code dealing with wage withholding. I have contacted various persons regarding the EDD position and hope to get it rectified with a technical correction in the current legislative session.

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