



Limited Liability Entities and Self Employment Tax Issues: New Tax Court Case Ruling

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Lately there has been a lot of discussion with attorneys who work with FBFM field staff and our clients concerning limited liability entities. Should they do business as a Limited Liability Company (LLC) or as a Family Limited Partnership (FLP) or a Limited Liability Limited Partnership (LLLLP)?

Farmers' net worth has increased so rapidly in the last couple of years that they have found the need to look at estate planning as well as entity planning. Often, we end up with an entity to hold the land and an entity to hold the machinery which does the actual farming. This has increased in good times as more college graduate children come back to the farm to continue the farming operation in multi-generational businesses. The entity that holds the land becomes a vessel to transfer ownership over time to the next generation by a series of gifts, or a large lifetime gift (up to \$5 million).

In this article we will talk about the tenant side of the business. In August 2011 there was a tax court case that sheds some more light on these entities and the application of self employment tax on earnings. In the Renkemeyer, Campbell & Weaver, LLP case the issue was this: do the partners of this law firm owe self employment tax on their limited partner share of earnings? This issue has been a question for several years and has now resurfaced. I think this case will offer some guidance on how IRS and the courts will treat these entities.

First, in 1977 IRS Code Section 1402 covers definition of self employment income and it says it is from a trade or business. IRS code section 1402(a)(13) excludes a limited partner from social security tax if the interest was just of an investment nature. Code Section 469(h)(2) was enacted in 1986 to define limited partners as not participating in partnership business activity. Since then, there have been no further Congressional amendments or guidance to directly address self employment issues in LLC's, LLP's, FLP's, and LLLLP's even though IRS issued proposed regulations to clarify the issue.

Second, we have seen an explosion in uses of entities to protect one part of the business from the other part. An example farmer starts a trucking business in addition to the farm. The first words an attorney would tell you is that you need a new entity for the truck to protect the farm in case there is an accident on the road.

The tax court decision in Renkemeyer suggests that distributive share of a partnership needs to be divided for self employment tax between return on capital and compensation for services rendered. This

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is similar to the treatment of shareholder employees of an S-corp who must separate reasonable compensation for their services from investment profits and dividends.

In conclusion, if a “duck” walks and squawks like a “duck” – then it is a “duck”. If there is work done, or if there is a guaranteed wage, or a wage or profit from work done then self employment tax is owed on it.

Hopefully, this will get you, as a business person, more informed when you talk to your attorney on your own situation because everybody’s situation is different.

In a future article in 2 weeks, I will discuss the differences and applications of the LLC’s, FLP’s, LLP’s, and LLLP’s in the landlord or investment side of the business.