Legal Opinion L-2002-10
August 20, 2002

U.S. Railroad Retirement Board
844 North Rush Street
Chicago Illinois, 60611-2092

Phone: (312) 751-7139
TTY: (312) 751-4701
Web: http://www.rrb.gov

TO : Suzanne Haynes
Chief of Records Analysis and Systems
Through: Ronald Russo
Director Policy and Systems
Office of Programs

FROM : Steven A. Bartholow
General Counsel

SUBJECT : **Limited Liability Company**
Last Person Employment/Current Connection

This is in reply to your inquiry of June 21, 2002, requesting my opinion as to whether a sole proprietor who converts his business to a limited liability company under the law of Missouri would be considered an employee of the new entity for purposes of determining whether he worked in non-railroad employment pursuant to sections 1(o) and 2(f)(6)(A) of the Railroad Retirement Act. For the reasons set forth below, in my opinion the limited liability company would not be his last non-railroad employment, and would not be regular employment which would break his current connection with the railroad industry.

Your background memorandum states that the subject individual, who is a former railroad employee (hereinafter the "employee"), is sole owner and manager of a restaurant in Missouri. He states that he has been advised that if he converts his sole proprietorship to a limited liability company ("LLC"), and then obtains in the name of the company a local license to serve alcoholic beverages, he can qualify for a less costly liability insurance premium than he would if he sold alcohol as a sole proprietor. He states that he would remain sole owner of the business, and that he would pass through all income from the business to himself for Federal income tax purposes.

Characterization of income from a LLC has previously been addressed by this office only in the context of the work restrictions incorporated into the Railroad Retirement Act from the Social Security Act. See Legal Opinion L-2000-8. These sections[1], by incorporating the deduction for excess earnings of section 203(b) of the Social Security Act, also thereby include the additional requirement that a self-employed individual must perform substantial services in the business before he or she is subject to reduction of benefits for that month, if earnings occur in the individual's "grace year". See section 203(f)(1) of the Social Security Act; regulations of the Social Security Administration at 20 CFR 404.435(d); and proposed Board regulation 230.15, (60 Fed. Reg. 42482, 42486) (August 16, 1995).[2] Beyond the grace year,

[1] The Social Security Act deduction for excess earnings applies to employee age and service annuities (section 2(f)(1) of the Act); spouse and divorced spouse annuities (section 2(f)(2) of the Act); survivor annuitants (section 2(g)(2) of Act); and employee and spouse annuity increases paid under the social security over-all minimum guaranty (section 3(f)(2) of the Act).

[2] The distinction between self-employment and work as an employee also arises under the sequential evaluation process used to determine total and permanent disability under the Board's regulations, which parallel those of the Social Security Administration. Where the disability applicant works as an employee, SSA regulations establish a presumption of gainful activity based on the amount of annual earnings. Where the disability applicant is self-employed, his or her ability to work is measured by a substantial services test. See regulations of the Social Security Administration at 20 CFR 404.1574 (employees), and 404.1575 (self-employed); and regulations of the Board at 20 CFR 220.143 and 220.144. Analysis of work in the disability context is beyond the scope of this memorandum.

U.S. Railroad Retirement Board
844 North Rush Street
Chicago Illinois, 60611-2092

Phone: (312) 751-7139
TTY: (312) 751-4701
Web: http://www.rrb.gov

earnings as an employee and from self-employment are charged against monthly benefits in the same manner. Legal Opinion L-2000-8 advised that for purposes of the foregoing excess earnings provisions characterization of income from a LLC to an annuitant should follow treatment of that income to that taxpayer under the Federal Internal Revenue Code. Where the LLC is treated as a partnership for Federal tax purposes, the income paid to the claimant is considered earned in self-employment. Where the LLC is treated as a corporation, payments are either salary or investment income, depending on the circumstances of a particular case.

Legal Opinion L-2000-8 did not address the effect of LLC income under the current connection and last person employment provisions. Current connection is defined by section 1(o) of the Railroad Retirement Act, which provides insofar as relevant here that an employee may break his or her current connection by engaging in "regular employment other than employment for an employer [in the railroad industry]" outside a specified time interval. The Board's regulations define regular employment to include full or part time employment, but to exclude self-employment. See 20 CFR 261.16. Certain benefit entitlement provisions under the Railroad Retirement Act require that the railroad employee must have a "current connection with the railroad industry". See regulations of the Board at 20 CFR 216.12. The deduction for work for last non-railroad employer is imposed on employee and spouse annuitants by section 2(f)(6)(A). Pursuant to section 2(f)(6)(A), the tier II annuity component and supplemental annuity of the railroad employee, and the tier II annuity component of his or her spouse, are subject to a reduction (limited to no more than half of the total component otherwise payable) for $1 of every $2 of:

> * * * compensation received by such individual from compensated service rendered in such month to the last person, or persons, by whom such individual was employed before the date on which the annuity of such individual * * * began to accrue * * * .

Regulations of the Board state that for purposes of determining last non-railroad employment under section 2(f)(6) of the Act, an officer of a corporation will be considered to be an employee of that corporation. See 20 CFR 216.22(c). Section 216.23(c) of the regulations further provides with respect to self-employment that:

> (c) *Self-employment*. Self-employment is work performed in an individual's own business, trade or profession as an independent contractor, rather than as an employee. An individual [who works in his or her own business] is not self-employed if the business is incorporated. * * *

Unlike the excess earnings provisions of the Social Security Act, where the distinction between employment and self-employment is not significant beyond the grace year, a determination that a work activity is self-employment for purposes of the current connection or last non-railroad employer provisions thus has a continuing effect on entitlement. In this context, Board regulation 216.23(c) incorporates consistent advice by this office[3] that an individual who has incorporated his or her business, and becomes

---

[3] The 1988 amendment to the Railroad Retirement Act of 1974 which added section 2(f)(6) also removed the former requirement of section 2(e)(3) that prevented payment of an annuity for any month in which the annuitant was in compensated service to his or her last non-railroad employer. See P.L. 100-647, section 7302(e) (102 Stat. 3757, 3777). Legal Opinion L-93-21 reviewed the legislative history of the 1988 amendment, and concluded that Congress intended the 2(f)(6) deduction to apply to the same individuals and in the same fashion as the non-payment provision of former section 2(e) which it superseded. Accordingly, the analysis applied
Footnote 3 (cont'd)

U.S. Railroad Retirement Board
844 North Rush Street
Chicago Illinois, 60611-2092

Phone: (312) 751-7139
TTY: (312) 751-4701
Web: http://www.rrb.gov

an officer of the corporation, is no longer engaged in self-employment. Section 216.23(c) is thus based on (1) the legal doctrine that a corporation is a legal person, distinct from its shareholders and officers, and (2) the specific inclusion of corporate officers within the definition of employee by section 1(k) of the Act. See, e.g. L-86-53 (the definition of employee for last non-railroad employer determinations is broader than the definition of employee of a railroad employer). The rule had been applied where the shares of the corporation are privately held by a small number of people (L-70-172, L-72-56), by two people (L-67-192), or even by one individual (L-67-243, L-65-176); where the corporation is formed under a professional corporation statute (L-82-93)(finding that former section 415-4 of the Illinois Professional Service Corporation Act, now SHA 805 ILCS 10/4, provides that professional services corporations are subject to the Illinois Business Corporation Act and hence are corporations); where the annuitant remains an officer although ownership of the shares is transferred (L-69-179) or where the owners of the corporation have elected to have its existence disregarded for Federal income tax purposes under Subchapter S of the Internal Revenue Code (L-68-70, L-86-111).

Whether the subject individual would be in the employ of the proposed LLC therefore depends upon whether the LLC may be considered to be a "corporation". As a general matter, a corporation has four essential legal characteristics: continuity of life, transferability of interest, liability for debts limited to corporate property, and power to sue, own property and act in its own name. See 18 AM JUR 2d Corporations section 2. For purposes of liability for Federal taxes, the Supreme Court has added the requirements that the entity be a joint enterprise among associates, organized for the conduct of a business. See: Morrissey v. Commissioner, 296 U.S. 344 (1935). These factors were applied in the leading case of United States v. Kintner, 216 F. 2d 418 (9th Cir., 1954) to determine that an entity with more corporate than non-corporate characteristics would be taxed as a corporation regardless of its status under state law. The IRS later adopted these factors, as applied by the Kintner decision, as the basis for determining whether an organization was a corporation. 26 CFR 301.7701-1to 301.7701-16 (1996)(the "Kintner regulations").

The nation's first LLC statute was enacted by Wyoming specifically to obtain non-corporate partnership classification under the Kintner regulations. See: Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. Cin. L. Rev. 95 (Fall 2001), at 97(n. 8). In 1988, the IRS agreed that an entity formed as a Wyoming LLC was not a corporation for Federal tax purposes. The IRS found under the Kintner regulations that the LLC lacked continuity of life because the LLC terminated with the death of a member, and lacked free transferability of interests because a LLC membership transferred to an outsider could not be granted full rights unless the transfer was approved unanimously by the remaining members. See Revenue Ruling 88-76, 1988-2 Cum. Bul. 360.

As other states adopted LLC statutes, the IRS provided specific guidelines under which it would find that a LLC lacked corporate characteristics under the Kintner regulations. See: Revenue Ruling 95-10, 1995-1 Cum. Bul. 501, 504. Also in 1995, the Commissioners on Uniform State Laws published the Uniform Limited Liability Act, which was based in part on the Wyoming statute, and which was intended to serve as a model for states in drafting LLC legislation. By July 1996, all 50 states and the District of Columbia had LLC statutes in place, and by 1997, the IRS had ruled LLCs formed in 18 states were not taxable as corporations. See: Allan Karnes, Roger Lirely, and Lori Cundiff, *The Limited Liability Company: A State by*

---

to determine the last non-railroad employer under former section 2(e) (and the predecessor section 2(d) of the Railroad Retirement Act of 1937, as amended) may also be applied to determine whether to apply the deduction now imposed by section 2(f)(6).

U.S. Railroad Retirement Board
844 North Rush Street
Chicago Illinois, 60611-2092

Phone: (312) 751-7139
TTY: (312) 751-4701
Web: http://www.rrb.gov

State Look at the New Pass-Through Entity, 1Detroit College of Law at Michigan State University Law Review 1, 5 (at n. 29)(1997).

In this process, the limited liability company evolved certain identifiable characteristics. Huss, supra, at 21-24, 29-33. At formation, a short document registering the company is filed with the relevant state official. Persons forming the company also enter into an "operating agreement" which specifies the relationship between themselves as "members" of the company, including allocation of membership interests, taxes, and profits. The operating agreement also provides whether the company will be run by the members, or by a manager selected by the members; the manager may be, but need not be, a member. As a general rule, all members and managers are not personally responsible for the debts and liabilities of the company solely because they are a member or manager.

Reacting to the increased number of LLCs, the IRS replaced the Kintner regulations effective January 1997. The preamble to the new final regulation stated:

> The existing regulations for classifying business organizations as * * * corporations * * * or as partnerships * * * are based on the historical differences under local law between partnerships and corporations. Treasury and the IRS believe that those rules have become increasingly formalistic. This document replaces those rules with a much simpler approach that generally is elective. 61 Fed. Reg. 66584, December 18, 1996.

Under the new regulations and with certain specified exceptions, an entity organized under a Federal or State statute which is not described by that statute as incorporated or as a corporation, may elect to be treated as either a partnership, corporation, or sole proprietorship. 26 CFR 301.7701-3(a); 301.7701-2(a) and 2(b)(1). The regulations further provide that a LLC with two or more members which does not file any election is treated as a partnership by default; and the existence of a LLC with a single member is disregarded. 26 CFR 301.7701-3(b). In sum, the question of whether a LLC is a corporation or a partnership for purposes of Federal taxation no longer concerns whether the LLC meets traditional corporate characteristics. The absence or presence of these characteristics has become irrelevant, and the treatment as a corporation or partnership is determined by wishes of the members. See: Carol Miller, Douglas March, Jack Karns, *Limited Liability Companies Before and After the January 1997 IRS "Check the Box" Regulations: Choice of Entity and Taxation Considerations*, 25 N. Ky. L. Rev. 585 (1998), at 603.

The foregoing analysis shows that the various state LLC statutes developed specifically to create an entity which would not meet the test applied under Federal tax law to determine an entity to be a corporation. The default classification of a LLC under the new IRS regulations shows that after an extensive period of review, the Internal Revenue Service has determined that a company formed under the state LLC statutes (as opposed to a company formally incorporated under the various state business corporation acts) per se lacks the characteristics of a corporation. The principles applied under the Internal Revenue Code themselves derived from the general characteristics of a corporation. These same principles have been used by the Board to determine that an entity is a "person" which would be an applicant's last non-railroad employer, or which would constitute regular non-railroad employment for purposes of the current connection test. In view of the determination of the IRS, it is my opinion that formation of a company under a LLC statute does not result in creation of a legal "person" which becomes the employer of a member of that LLC for purposes of sections 1(o) and 2(f)(6) of the Railroad Retirement Act.[4] This would be the case regardless of whether the LLC elects to classify itself as a corporation under

[4] I should note that an individual working for the company, who is not a member and therefore has no equity in the company, would be an employee just as he or she would be if working a concern run by partners or by a sole proprietor.

U.S. Railroad Retirement Board
844 North Rush Street
Chicago Illinois, 60611-2092

Phone: (312) 751-7139
TTY: (312) 751-4701
Web: http://www.rrb.gov

the Code. See L-68-70, L-86-111(corporation electing to report income under Subchapter S of the Code does not affect its status under the Railroad Retirement Act).

In the case you submitted, I assume that the former railroad employee intends to create a LLC with himself as the sole member, a form that is permitted under Missouri law. See Mo. Ann. Stat. 347.017. Consistent with the foregoing discussion, his continued work activity in his business would be self-employment which would not affect his current connection and would not trigger the deduction for last non-railroad employment.