

March 10, 2000
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TO : Joseph M. Waechter, Jr.
Assistant to the Management Member

FROM : Steven A. Bartholow
General Counsel

SUBJECT : Excess Earnings
Limited Liability Corporations

This is in reply to your inquiry as to how income from limited liability corporations (LLC) is to be treated in regard to the excess earnings provisions of the Social Security Act.

LLCs are generally classified as partnerships for the purposes of federal income taxes. Thus, members of LLCs are treated as partners. A general summary of social security law¹ indicates that, while income paid to a general partner would be considered self-employment income and therefore subject to the excess earnings test, income paid to limited partners would not be considered earnings unless that income is paid for services rendered².

While it is not entirely clear what constitutes a general, as compared to a limited, member of an LLC, an LLC should be treated as a partnership for the purpose of determining whether payments by the LLC to members constitute earnings from employment or self-employment.

¹ 1999 Social Security Explained, & 409.

² All earnings from LLCs owned by one individual would be regarded as self-employment income and would be subject to the earnings test. A member of an LLC that is taxed as a corporation would be subject to the excess earnings test on his or her salary, but not on dividends or distributions.

Accordingly, it would then be the case that an individual would be a limited member (analogous to a limited partner) unless that individual is personally liable for the debts of the LLC, has authority to contract for it, and works for it a substantial amount of time³.

The LLC is a relatively new phenomenon, and there is as yet no complete answer to your question. For the purposes of determining whether FICA tax is due on income received from an LLC, it must be decided in each case whether that income is to be reported as employment or self-employment income, or as a return on investment. The result reached in that determination should be applied to the earnings test as well.

³ Other criteria which may be used include the seven tests used by the Internal Revenue Service to distinguish between passive and active income: participation by the individual of more than 500 hours, the individual's participation constitutes substantially all of the participation of all individuals, participation of more than 100 hours with no one else participating more, etc. Another approach suggested by 1999 Social Security Explained would be to subject income from an LLC to the earnings test only to the extent that that income represents services rendered. A third approach suggested would be to treat all income from an LLC as subject to the earnings test.