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Dealing With the Differences in Compensating Corporate Executives and LLC Members

New thinking is required with respect to regular and incentive compensation, deferred compensation, fringe benefits, retirement plans, and many more issues.

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While most of the significant operating concerns for LLCs have been resolved, a troublesome issue in many situations is how to compensate LLC members. Manufacturing, wholesale, and retail businesses traditionally have been corporations, with relatively simple, straightforward tax rules for compensating employees. They have a variety of methods available to entice, reward, and retain competent personnel. Employees are able to participate in tax-favored fringe benefit plans without recognizing income while the employer can take a deduction for the cost. Employee taxes are paid through employer withholding on employee wages. Equity-based compensation is frequently used with generally predictable tax consequences for the corporate employer and the employee. The problems arise because manufacturing, wholesale, and retail business are now becoming LLCs.

In general, the tax treatment of regular employees of an LLC is no different than for any other employer. If the individual providing services is also an LLC member, however, the individual most likely will be treated as a partner in a partnership. Because it is fairly common for a manufacturing, wholesale, or retail business operated in LLC form to be run by individual members who have long executive experience as corporate employees, the change in tax status can be unsettling.

Example. A start-up computer component manufacturer is formed as an LLC. Like any growing company, the LLC wants to put together a management team of experienced individuals. These individuals probably will not make immediate property contributions but will help organize, manage, and guide the start-up company. The LLC and the management team have negotiated separate employment contracts and base salary, yet one last item remains to be negotiated. What kind of participation will the management team have in the growth and success of the business? Simply put, these executives want an equity stake in the business that may be part of a plan to increase their interests down the road. To provide this desired participation, each is given a small percentage profits interest that technically makes them members of the LLC for tax purposes. The LLC also establishes a plan that provides for future incentive compensation through equity grants or options.

EMPLOYEE OR PARTNER?
It is not really a stretch to assume that the individual executives described above are employees for all purposes of the Code with respect to their salaries, given that

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they have employment contracts independent from the LLC's operating agreement. Section 707(a) provides that "if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner." If an LLC member provides services and there is a related direct or indirect allocation or distribution to that member, and if the services and the distribution could be viewed together as occurring between the LLC and the member other than in his capacity as a member, perhaps a member could be classified as an employee.

If payments are made to a partner for services, and without regard to partnership income, under Section 707(c) the partnership deducts such amounts and the partner has ordinary income. Reg. 1.707-1(c) provides additional insight into the character of payments made to a partner unrelated to the partnership's taxable income: "...a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc." Based on the history of partner compensation through guaranteed payments, it seems that guaranteed payments should include nonstatutory employee fringe benefits provided as compensation.

At first blush, our hypothetical start-up LLC might argue that the executives' salary arrangements should meet the requirements under Section 707(a) as a transaction between the LLC and a member acting in a capacity other than as a member, and as such would cause the executives to be treated as employees receiving wages. In general, the income tax consequences of the salary payments to the executives and the LLC are the same (except for the timing of the LLC's compensation deduction and member compensation) under Sections 707(a) and 707(c), which govern the tax treatment of LLC compensation to members. The amounts paid generally are deductible under Section 162 by the LLC and would be included in gross income under Section 61 by the executive-members.

Sections 707(a) and (c) were first enacted as part of the 1954 Code to reconcile some perceived inconsistencies when services were rendered by partners. In particular, Congress wanted to ensure, for example, that a partner was fully taxed on cash paid to him, not in his capacity as a partner, for providing oil drilling services to the partnership. Such drilling expenses ordinarily would have been capitalized by the partnership. Under old law, it was uncertain as to whether only a part of the cash for services should be recognized as income, because part of the services were with respect to self-generated benefits. If the partner had performed the services in a sole proprietorship, he would not have recognized income or capitalized any imputed cost of his services.

The tax treatment of partner compensation was the subject of much uncertainty and litigation since 1954. In 1981, the IRS attempted to provide needed guidance regarding classification of payments under Section 707(a) or 707(c). Rev. Ruls. 81-300 and 81-301 contrasted the two subsections by stating that services provided in a Section 707(a) context are generally those the partner provides to "others as part of [the partner's] regular trade or business..." but services provided in a Section 707(c) context are generally services related to the intended purpose of the partnership.

1. Transfers of capital interests in LLCs for services can have distinctively complex consequences to the service-member, the other LLC members, and the LLC. Some of these issues are discussed later in this article.

2. Under Section 761(a)'s broad definition of partnership agreements, the executives' employment agreements might easily be deemed to be an integral part of the LLC's operating agreement. Because the employment agreements might be subsumed by the LLC operating agreement, there is also a good chance that the total arrangement could just as easily be interpreted as detailing the executives' compensation as partners in a partnership.


5. Compare Lloyd, 15 BTA 82 (1929), with the dissent in Wegener, 119 F.2d 49 (CA-5, 1941), aff'd 41 BTA 857 (1940) (reaching different conclusions on how a partnership should deal with a partner as an outsider). See also Rev. Rul. 55-30, 1955-1 CB 430. If a fixed salary was a withdrawal of capital, taxable to the extent it represented other partners' capital.

6. 1981-2 CB 143 and 144.

7. In Rev. Rul. 81-300, the IRS held that fees received by general partners based on 5% of gross rentals were Section 707(c) guaranteed payments. But in Rev. Rul. 81-301, the IRS held that an advisor-general partner who provided similar services received compensation payments in a capacity other than as a partner under Section 707(a). Rev. Rul. 81-300 was generally promulgated to support the Service's position that Section 707(c) payments did not have to be fixed amounts such as salary. It specifically rejected the conclusion in Pratt, 64 TC 203 (1975), aff'd in part and rev'd in part 550 F.2d 1023 (CA-5, 1976), which held that partner payments based on a percentage of gross rents were allocations of income, not Section 707(a) payments (the court passed on ruling that they were Section 707(c) payments).
The 1984 Amendments
In DRA '84, Congress added new Section 707(a)(2)(A) to deal with disguised fees for services and payments for property. Congress was concerned that partnerships had been used to effectively circumvent the requirement of capitalization of certain expenses and other rules concerning expenses by making allocations of income and corresponding distributions to transitory partners in place of direct payments for property or services.8 Section 707(a)(2)(A) was meant to capture transactions where the partner generally would be treated as an independent contractor so that services related to start-up could be properly capitalized. In addition, the 1984 Senate Report indicated that Congress did "...not intend to create any inference regarding the tax treatment of the transactions described under current law."9 In contrast to these comments, however, the Finance Committee guaranteed further confusion by stating that it intended the "provisions will lead to the conclusions contained in [Rev. Ruls. 81-300 and 81-301] except that the transaction in Rev. Rul. 81-300 would be treated as a transaction described in Section 707(a)."10 Despite this explicit reference in the legislative history, the IRS has not invalidated Rev. Rul. 81-300, and taxpayers presumably still can rely on it to treat similar payments as guaranteed payments. Furthermore, Section 707(a) states that it applies "except as otherwise provided in this Section [707]...." Therefore, other provisions in Section 707 such as Section 707(c) should be considered as to their applicability before Section 707(a) would apply.

The Senate Report also listed six factors that could be considered in determining whether a transaction between a partner and partnership would result in a Section 707(a) distribution.11 Of these, one is irrelevant as it deals with disguised sales of property. The application of the remaining five factors to our LLC employee-member scenario is discussed below.

Entrepreneurial risk. First and most important is whether the payment is subject to significant entrepreneurial risk. In our hypothetical, the executive-members are guaranteed the payment of salaries like any employee of the business; the risk of nonpayment is minimal. The lack of entrepreneurial risk would support an employer-employee relationship.

Transitory status. The second factor is whether partner status is transitory; a continuing partner status, however, does not prove otherwise. Although a transitory partner status indicates the likelihood of Section 707(a) treatment, in our example the executive-members will retain their profit interests indefinitely. Because this factor points in only one direction, our executives’ continuing status does not prove that they are otherwise acting as partners.

Timing. The third factor is whether the payment closely follows in time the performance of services. This factor also supports the employer-employee relationship in our scenario because the salary payments are generally made on a biweekly or semi-monthly schedule, closely following the performance of services.

Tax motivation. Fourth, did the recipient become a partner primarily for tax benefits? It is very unlikely that the executive-members described in our scenario would be primarily seeking partner tax treatment. It is more likely that in taking a membership interest, these persons typically are seeking an economic benefit related to the effectiveness of the services rendered.

Relative size. The fifth factor is whether the recipient’s interest in the partnership is small in relation to the payment or allocation in question. Given the facts in our example, the member’s salary is very likely to eclipse the allocable share of LLC profits related to the member interests.

After analyzing the five factors one might conclude that an employer-employee relationship exists with the executive-members, and that all payments to or on behalf of these executives resembling salary should be treated as payments made pursuant to Section 707(a). Further, it would seem that for all purposes of the Code the relationship should be respected, including fringe benefits, employer withholding, and FICA taxes. Unfortunately, after years of definition and litigation, it is not clear that the executives in this case would be treated as employees. In fact, in all probability, they more likely would be treated as partners receiving guaranteed payments because the ser-
services provided appear to be in the capacity as partners.

Arguments for Employee Treatment
The primary argument for treating such members as employees stems from the desire to apply employee fringe benefit treatment to LLC payments. Certain fringe benefits are available to partners by specific reference. Certain key fringe benefits such as medical care, however, are includable in a partner's compensation. In Armstrong v. Phinney, the taxpayer argued that a ranch partnership should be able to deduct, under Section 119, meals and lodging it provided as an employer to a partner living on the premises and rendering services. The district court disagreed and held that a partner cannot be an employee for purposes of Section 119. The Fifth Circuit remanded, however, for a determination of whether the partner was in fact an employee of the partnership for purposes of Sections 119 and 707(a). The suit apparently was settled, as there is no record of further action in the lower court. Although Armstrong supports the possibility that a partner can be an employee for purposes of Section 119 in the Fifth Circuit, it does not necessarily extend to other employee fringe benefits. On the contrary, numerous cases hold that such a relationship cannot exist between a partner and a partnership.

The size of the membership interest appears to be irrelevant for purposes of disallowing fringe benefits to LLC members. Section 1372 provides that an S corporation is a partnership for purposes of employee fringe benefits, and that a more-than-2% shareholder will be treated as a partner. Nothing in Subchapter K is similar to the S corporation minimum percentage interest rule. It is fair to conclude that Congress acknowledged on enactment of Section 1372 that a partner holding any interest in a partnership could not be an employee for fringe benefit purposes.

In sum, compensation to a member must be analyzed under the facts and circumstances to determine the proper relationship between the member and the LLC for tax purposes. It is unlikely that an absolute standard can be applied. The first step is to consider whether the payment relates to the taxable income of the partnership. If so, it may represent an allocable share of partnership income under Section 704(b). Second, is the payment for services in a capacity as a partner under Section 707(c) consistent with the purpose and objectives of the LLC? Third, is the payment, when considered in connection with a contribution of services or property, properly characterized under Section 707(a) as a transaction between a partner and one who is not a partner? Only if the answer to the last question is yes is it possible for an LLC member to be characterized as an employee—a likelihood that will be infrequent at best. In most situations, it will be simply too hard to show that a particular member's services are being provided to the LLC in a capacity other than as a partner.

State Employment Laws
The issue of whether LLCs are employers under various state laws such as unemployment and workers' compensation taxes has been subjected to independent treatment. For example, several states had to specifically amend their statutes to include the LLC as an employer under their employment laws. The various statutes typically agree that only members providing services in an employee context will be covered but are not consistent as to the requisite amount and character of services. Furthermore, these characterizations of employee status by state employment laws do not have any bearing on the nature and treatment of LLC members for federal income tax purposes. LLCs and their members should be aware of the potential for different treatment under state employment laws and consider the impact on service-providing members.
GENERAL PARTNER OR LIMITED PARTNER?

At present, there is no uniform treatment under the Code as to when an LLC member might be a general or limited partner. Although members have limited liability like limited partners, often the level of management or services provided to the LLC by the member in the capacity of a member more closely resembles a general partner. For the moment, the IRS has taken a patchwork approach to defining whether the LLC member is a general or limited partner by providing guidance for self-employment tax purposes and for designating the tax matters person (TMP). And in the case of self-employment taxes, a distinction is made between members based on state law classifications of general and limited partners. But, in general, the status of the LLC member as either a general or limited partner will not affect the tax consequences of a member’s compensation.

COMPENSATING LLC MEMBERS AS PARTNERS

Accepting our premise that LLC members more than likely will be treated as partners for compensation purposes, a review of the tax consequences of such treatment is appropriate. For the most part, LLC members familiar with having employee status will need to adapt to being treated as partners for tax purposes. A former employee who is now an LLC member might react negatively to the differences at first. The wide-ranging flexibility of a partnership can be put to good use, however, in designing an LLC member’s compensation package to ameliorate at least some of the undesirable consequences of being treated as a partner.

Information Reporting and Estimated Taxes

The LLC member will receive a Schedule K-1 reflecting the member’s allocable portion of the LLC’s income and deduction items and any guaranteed payments for capital or services rendered. New members may resist the notion of a K-1 but if properly educated will quickly adapt to not receiving the perennial W-2 reflecting wages earned for the year.

Income tax withholding on wages imposes a level and constant reduction in cash-flow for employees, but it also provides a ready-made source of funds for payment of income taxes at year-end. As a partner in a partnership, the LLC member will not be able to rely on the imposed discipline of income tax withholding but will need to plan for quarterly estimated tax payments. This likely would be done through personal cash-flow planning from the executive-member’s compensation income. Alternatively, to assist all of its members, the LLC could consider accumulating sufficient cash to make quarterly cash distributions to its members to be used for estimated tax payments. In fact, the LLC operating agreement should provide for quarterly distributions, especially if minority members are present who do not control the LLC’s distributions.

Self-Employment Taxes

Employees and employers are subject to FICA taxes on wages paid, while sole proprietors and partners are subject to the self-employment tax rules in Section 1401. A general partner’s distributive share of partnership income is subject to the self-employment tax while a limited partner’s earnings are not unless guaranteed payments are received for services rendered. Prop. Reg. 1.1402(a)-18 made it clear that members of LLCs that are taxed as partnerships will be subject to the self-employment tax. Under Prop. Reg. 1.1402(a)-18(a), if the LLC is member-managed, all members’ earnings are subject to self-employment taxes. If the LLC is manager-managed, however, it is possible under the proposed rules for certain LLC members to be treated as limited partners not subject to self-employment taxes. Under Prop. Reg. 1.1402(a)-18(b), a member is a limited partner if the member is not a manager, the LLC could have been formed as a limited partnership in the same jurisdiction, and the member could have qualified as a limited partner under the limited partnership act.

LLC members bear the entire economic burden of their employ-

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19 Section 1402(a)(13).

20 See also Ltr. Rul. 9525058 and Keatinge and Wolf-Smith, supra note 18. The Service, however, may be having second thoughts about its approach to the self-employment tax treatment of LLC members. William P. O’Shea, chief of IRS Branch 3, Pass-Throughs and Special Industries, was reported to have characterized the Proposed Regulations as taking too narrow an approach to the question of who is a general partner and who is a limited partner. See “IRS Looking to Revamp Regulations on Self-Employment Tax Treatment of LLCs,” BNA Daily Tax Report, 6/6/96, page G-2.
ment taxes as opposed to sharing one-half of those taxes amongst the other members. By contrast, a corporation (and therefore the shareholders) bears the economic burden of one-half of all employment taxes for its employees. Thus, a former employee who is now an LLC member receiving salary-like payments would pay an additional $5,337 in self-employment taxes on the first $100,000 of compensation payments in 1996.21 This inequity could be partially redressed through a gross-up of executive-member compensation to cover the shortfall in after-tax dollars.

Taxable Fringe Benefits

As in our hypothetical, many LLCs today are operating companies whose members perform services in return for compensation. Usually, such compensation will include commonplace fringe benefits such as health and life insurance and free parking. For employees, some or all of these benefits are excluded from taxable income;

21 The 6.2% OASDI (regular FICA) rate multiplied by the 1996 wage base of $62,700, plus the 1.45% HI (Medicare rate) multiplied by the full payment of $100,000 (the HI tax, of course, applies to all income without limitation). The available deduction under Section 164(f) for one half of self-employment taxes mitigates the impact of the tax only somewhat.

22 Other benefits excluded from employee compensation but taxable to partners in partnerships are the $5,000 death benefit exclusion (Section 101(b)); employer payments to accident and health plans (Section 106); meals and lodging for the convenience of the employer (Section 119); and benefits received under cafeteria plans (Section 125).

23 See note 12, supra.

24 1991-1 CB 184. Reg. 1.707-1(c) provides that a partner who receives a guaranteed payment is not regarded as an employee with regard to income tax withholding, deferred compensation, etc.

25 Section 1372(a) applies only for purposes of Subtitle A of the Code and not Subtitle C, which covers employment taxes. See Ann. 92-16, 1992-5 IRB 53.

what about an LLC member who receives comparable benefits for the services rendered to the LLC?

Although there is no direct guidance, it would seem appropriate to treat the LLC member’s fringe benefits in the same manner as a partner’s fringe benefits. This will mean that certain fringe benefits normally excluded in a corporate setting will be taxable to the LLC member, including group-term life insurance (Section 79) and payments received under accident or health plans (Section 105).22 Fortunately, other fringe benefits are excluded from both employee and partner compensation, including working condition fringes (Section 132).23

The only official guidance the Service has rendered on the tax treatment of fringe benefits in a partner-partnership context is Rev. Rul. 91-26,24 which is equally applicable to LLC members. In general, the Ruling treats health insurance provided to partners as Section 707(c) guaranteed payments. Under Section 707(c), if payments are made to a partner in return for services, and the payments are determined without regard to the income of the partnership, the payments are considered paid to one who is not a member of the partnership but only for purposes of Sections 61 and 162. Because guaranteed payments are treated as distributive share of partnership income, the FMV of the fringe benefits is included in partner income. As an alternative, the Ruling permits the partnership to not take a deduction and to treat health insurance benefits as an in-kind distribution to the partner.

Under Section 162(l), the LLC member who is treated as a partner will be allowed a 30% deduction for health insurance premiums paid. Another unexpected discrepancy for LLC members is that income attributable to health insurance premiums is subject to self-employment taxes under Section 1401(a). In contrast, for FICA purposes insurance benefits are excluded from wages subject to tax under Section 3121(a)(2). Therefore, although more-than-2% shareholders in an S corporation are required to treat health insurance premiums the same as partners in a partnership for income tax purposes, such insurance premiums are not wages for purposes of employment taxes.26 This disparity between employees and self-employed individuals is not necessarily significant but might be worth considering when negotiating an LLC employee-member’s salary and compensation package. (For another withholding problem in an LLC, see the sidebar on page 16, “The Common Paymaster Issue.”)

Self-Insurance

More and more companies are providing health coverage to their employees and partners in the form of self-insurance. As mentioned above, an employee excludes benefits received from a health plan, including a plan self-insured by the employer. In the partnership context, however, self-insurance becomes an issue. True insurance involves risk shifting between the employer and the insurance company, while in a self-insurance arrangement the employer bears the risks for its employees’ or partners’ health
The Common Paymaster Issue

Another potential bump in the road for LLCs is the lack of common paymaster treatment. Because employers bear the burden of one-half of the employment tax on an employee's wages, two separate businesses that employ the same individual are actually assessed twice on the OASDI portion that otherwise would be limited in the case of individuals with combined wages exceeding the wage base. This is particularly unfair for related entities employing the same individual. It is also unfair to the employee, because excess amounts are withheld, and unavailable to the employee until an individual income tax return is filed for refund.

Example. In 1996, employee A works for related corporations X and Y. A is paid a salary of $100,000 by X and another $100,000 by Y. As employers, both X and Y withhold a total of $10,675 from A's wages and pay a matching $10,675 for the employer's share. A has had an overwithholding of $3,887 (the limit is 6.2% of $62,700 for OASDI) that will be refunded on filing an individual income tax return in 1997. The related corporations also have paid twice on this limit, but are not going to receive a refund.

Fortunately for related corporations, the IRS has provided relief from this through Section 3121(s) and the use of a "common paymaster." If the corporations are related, and a common paymaster is used to compensate the employee, the wages are subject to FICA as if there were only one employer. Using the above example, A would have only $6,787 withheld, and X and Y would pay a matching $6,787. The common paymaster provision is available to all corporations, including those electing S status.

Unfortunately, LLCs taxed as partnerships are not eligible for common paymaster relief. Even if two LLCs are otherwise related, Section 3121(s) is limited to entities taxed as corporations. It appears that a legislative change would be required to make this provision available to other entities. Currently there are no proposals that would make this change.

costs. Generally an outside party merely administers the self-insured plan. A partner, and thus an LLC member, includes insurance premiums paid by the LLC in taxable compensation under Section 707(c). On the other hand, if the LLC maintains a self-insured health plan, it appears LLC members will find that actual health benefits (payments on submitted claims) are compensation when received and deductions for health costs generally will be allocated to all LLC members per the LLC agreement.

The taxability of self-insured benefits paid to partners in partnerships (and therefore LLC members) is a controversial and unsettled area. If self-insured health benefits are taxable to LLC members when paid, which may coincide with a serious illness of the member or a dependent, the tax consequences in some circumstances can be financially disastrous. Although an itemized medical expense deduction is available, it will at best only offset a portion of the noncash compensation deemed received. In fact, in limited situations, the tax liability of the individual could exceed cash income for the year.

Alternative interpretations of the rules, however, make it possible to argue there is sufficient shifting of risk in an LLC's self-insured plan to treat the plan effectively as an insurance arrangement. As a practical alternative to this uncertainty, it might be worthwhile to insure the LLC members apart from the self-insurance arrangement covering general employees. True, commercial insurance may be more expensive than a self-insured plan but the certainty of tax result may be worth the additional costs. The insurance premiums will be taxable compensation, but this approach will level out the LLC member's income. As self-insurance grows in popularity and conventional insurance costs increase, LLC members will have to assess the uncertainty in this area and determine if they

26 Under Reg. 1.105-5(b), if an LLC member (as a self-employed person) receives accident or health benefits under a self-insured plan, the benefits are taxable as compensation to the LLC member when received and are not excludable under Sections 104 and 105.

27 For example, an individual with $50,000 of cash compensation and $2 million of self-insured medical benefits would have a tax liability of approximately $38,000 (AGI is $2,030,000; deductible medical expenses are $1,836,200, i.e., $2 million less 7.5% of AGI, resulting in $203,750 of taxable income). Thus, in-kind medical benefits can result in a tax catastrophe for a self-insured, self-employed LLC member in the event of a catastrophic medical situation, where the cash distributed will be less than the resulting income tax liability.

want to make alternative arrangements to cover their health benefits.

Deferred Compensation
A nonqualified deferred compensation plan is a contractual arrangement between employer and employee providing for the deferred payment of compensation in the future. An effective deferral requires avoiding constructive receipt, which generally means any funds set aside to pay the deferred compensation will need to be at the risk of creditors.

A deferred compensation program in an LLC setting works much the same way as in the normal employer-employee context, but several nuances are peculiar to partnerships. First, an LLC member’s allocable distributive share of the LLC’s income and losses cannot be “deferred.” These items pass through to the LLC member under Section 702 and are taxable in the member’s tax year in which the LLC’s year ends. But, if the other partners agree, special allocations can be made in the LLC operating agreement to allocate certain items away from specific LLC members. Because special allocations need to be reflected in member capital accounts, there will be a day of reckoning when the LLC liquidates.

If the LLC member is slated to receive guaranteed payments under Section 707(c), however, it is possible to set up a nonqualified arrangement to defer these payments. Under Reg. 1.707-1(c), these payments would be ordinary income taxable to the member in the member’s tax year in which ends the LLC’s year in which the payments are deductible. By virtue of the deferred compensation arrangement between the LLC and its member, the LLC can control when the payment is made, which, under the LLC’s method of accounting, will determine when the payment would be deductible to the LLC. Deferred amounts result in an across-the-board increase of distributable income to all LLC members based on the LLC agreement to allocate income, including the member electing to defer receipt of payment. Since the member cannot defer his allocable share of LLC income, a portion of the deferred income will flow through to him in the year of deferral. In this regard, compared to employee deferred compensation, the LLC member’s current tax benefit from deferred compensation benefit is diminished by increased distributable income to himself.

Equity-Based Compensation
Many corporate employers use equity-based compensation, in the form of stock or stock options, to motivate employees. When these same individuals find themselves in the employ of an LLC, or members of an LLC, they may expect a similar “piece of the action” in the form of LLC interests. The LLC, like any partnership, is flexible enough to accommodate equity-based compensation but the arrangements may have quite different tax consequences than commonly found in similar corporate plans. An LLC can transfer an interest to an employee or existing member in the form of a capital/profits interest, or just a profits interest, or as an option to acquire either a capital or profits interest or both.

Capital interests. There is no consensus as to the tax consequences for a partnership if a transfer of a capital interest takes place when the partnership has unrealized appreciation in its assets. The preferred analysis is to treat the partnership as transferring to the service partner a proportional interest in all its assets. This would trigger unrealized appreciation in the partnership assets at the transfer under Section 1001. If the service partner assumes any partnership liabilities under Section 752(d) on entering the partnership, then the deemed consideration paid for the interests would include not only the FMV of services rendered but also the liabilities assumed. This deemed consideration could increase the unrealized appreciation recognized by the partnership and taxable to the partners while the partnership’s deduction for compensation is only the FMV of the services (net of any liabilities).

Section 83, which governs the timing of the compensation deduction for the LLC, provides yet another set of rules that need to be examined in analyzing the tax consequences of equity-based compensation made available to LLC members. If property is trans-
ferred in exchange for services, under Section 83(a) the excess of the FMV of the property at the lapse of any substantial risks of forfeiture over any amounts paid for the property will be taxable compensation at the time of the lapse.

The Section 83 rules were enacted by TRA '69, and it is not clear whether Congress in any way intended to override the general rules adopted under Section 721, or whether Section 83 and Section 721 are even mutually exclusive. Reg. 1.721-1(b)(1) makes it clear that if any partner gives up any right to be repaid capital contributions, in favor of another partner as compensation for services, the value of such transferred capital interest is taxable compensation to the transferee partner. The Regulation goes on to state that the value of such an interest will be a guaranteed payment under Section 707(c) deductible under the partnership's accounting method. Given that Section 83 merely governs the timing of the compensation, it would seem the two sections are wholly consistent and appear to dovetail with each other.

Based on the rules set forth above, if an employee or existing LLC member were to receive an LLC capital/profits interest in exchange for services, it is possible to read the Section 721 Regulations to treat the receipt of the interests as a guaranteed payment taxable to the transferee partner and deductible to the LLC when the interest is received without any unrealized appreciation in LLC assets being recognized. These tax consequences are comparable to the receipt of stock by a corporate employee where the corporation recognizes no gain under Section 1032 on issuing its stock for property.34 Contrast however, the issuance of LLC interests to a new or existing member with a taxable transfer of a proportionate share of LLC assets in exchange for services under Section 1001. This approach would create taxable income to the LLC for any unrealized appreciation in LLC assets deemed to be transferred.

Example. Since its inception three years ago, ABC has been operating as an LLC treated as a partnership. ABC is in the software development business and has highly appreciated assets. ABC would like D to enter the LLC as a new member with a 10% capital and profits interest, and assist with the development of new software products. When D becomes a member, ABC's assets have a value of $20,000 but are subject to recourse liabilities of $10,000. The ABC assets are self-developed and have a zero tax basis. The value of the 10% interest that D will receive in exchange for his services is $1,000.

Under the Section 721 Regulations, 10% of ABC's LLC interests issued to D would be a guaranteed payment deductible by ABC. On the other hand, if issuing the 10% interest to D is treated as a transfer of 10% of ABC's assets to D, ABC would recognize $1,000 of gain (10% of $10,000 net asset value less zero basis) and would take a $1,000 compensation deduction. Because D is deemed to assume a proportionate share of the LLC's liabilities under Section 752, however, additional gain of $1,000 would be recognized by ABC with no offsetting increase in the compensation deduction.35 Under Section 706(c)(1), ABC's tax year remains open on the entry of D as a new member. This means the $1,000 compensation deduction and the $2,000 gain recognized will be shared by all the partners based on their allocable distributive share of LLC income and deduction items.

There is potential for additional complications if existing LLC members have contributed low-basis, high-value assets to the LLC. Under Section 704(c), pre-contribution unrealized gains recognized in the partnership will be allocated to the contributing partner but the Section 707(c) payment deduction will be allocated according to the LLC operating agreement. The result, while economi-

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34 A "substantial risk of forfeiture" exists if the rights to the full enjoyment of the property transferred are conditioned on the future performance of substantial services. Section 83(c).

35 If a corporation uses property other than its stock to satisfy its obligations for services, Rev. Rul. 75-41 provides that gain is recognized in the difference between the transferor's basis and the sum of the deemed compensation to the transferee plus amounts paid. This result is more akin to an LLC's recognizing gain on transfers of its interests to service members.

36 Under Section 752(d), if there is a sale or exchange of a partnership interest, partnership liabilities are to be treated as liabilities are treated in the sale of any asset, e.g., the assumption thereof is additional consideration for the partnership interest. Under Section 752(b), because most LLC debt is nonrecourse to its members, when a new member is admitted to the LLC there will not be any shifting of liabilities to cause deemed distributions or contributions unless there is excess nonrecourse debt per Reg. 1.752-3(a)(3). A partner's share of Section 704(b) minimum gain and the Section 704(c) partnership minimum gain will not shift in an LLC context. Reg. 1.752- 3(a)(1) and (2). For more on Section 752 considerations in an LLC context, see Pil- low, "Allocating LLC Liabilities After Rev. Rul. 95-41: IRS Provides Helpful Guidance," 2 JLLC 99 (Winter 1995).
cally appropriate, will be that an LLC member may unintentionally recognize income without an equal and offsetting deduction. LLCs should clearly take this consequence into account in considering transferring current or future capital interests.

In sum, there is a key difference between corporate and LLC consequences in using LLC capital interests as compensation compared with corporate stock. The value to the LLC of any deduction can be diminished by gains recognized on the transfer of LLC interests for services, while a corporate employer is allowed a deduction for the full amount of deemed compensation but does not recognize any gain on issuance of its own shares.36

Profits interests. In contrast to the capital interest, the Eighth Circuit concluded in Campbell37 that there is no current compensation to the transferee partner who receives a profits interest. The court based its conclusion on the speculative value of a profits interest and not on an application of the Subchapter K rules to the receipt of a partnership interest. In Rev. Proc. 93-27,38 the Service followed the Campbell decision and held that the receipt of a profits interest generally will not result in a taxable event for either the partnership or the partner.

After Campbell, there should be no taxable compensation if an LLC member were to receive a profits interest because of the speculative value of such an interest. Campbell does not clarify whether Section 83 applies to a profits interest. If the profits interest is subject to a substantial risk of forfeiture, it may be advisable to make a protective Section 83(b) election to assure that any capital that accumulates before the restrictions lapse is not then taxable to the LLC member.39

Issuing profits interests to LLC members can avoid the taxable consequences—current compensation—of issuing capital interests. If the profits are allowed to accumulate inside the partnership, the LLC member can develop a capital interest over time. A Section 83(b) election could foreclose any additional income when restrictions lapse. Another alternative would be to simply distribute cash to the member providing services with the option to purchase additional interests immediately as a capital contribution under Section 721.

Options to Acquire LLC Interests
Although LLCs cannot issue "stock" options, they can issue nonqualified options to purchase LLC units. In general, the grant of an option to purchase units, either to an existing member or to an employee not yet an equity holder, does not have a taxable consequence for the LLC. If the option is granted to an LLC member in exchange for services, the Section 83 rules may come into play. Presumably any such option would not be freely transferable, but might well be subject to a substantial risk of forfeiture to assure that the holder of the option satisfactorily performs services under the option agreement. Although options technically are not property for purposes of Section 83, the issuance of options still can come within the purview of this section on grant if they have a readily ascertainable FMV.40 If subject to Section 83, the excess of the FMV of the LLC interest over the strike price, plus the value of the option privilege, generally is includable in the income of the option holder when any substantial risk of forfeiture lapses.

If the option holder is an LLC member, what is the proper treatment of the compensation? Is it a distributable share of LLC income or a guaranteed payment? Each situation must be evaluated in light of its own facts, but the most common treatment would be a guaranteed payment. As discussed above, under Section 707(c) a guaranteed payment is one made to a partner in his capacity as a partner but without regard to partnership income. Here, the spread between the FMV of the option and its strike price would be a “payment” in the year the restriction lapses, creating a deduction for the LLC and income to the LLC member.

If the option is granted to a non-LLC member, the rules of Section 83 would work in the normal con-
text of the employer-employee relationship. This means that Section 83 would come into play and income would result to the option holder at the time of exercise or when any substantial risks of forfeiture lapses, if later. This consequence is straightforward but the actual method of recognition and reporting is somewhat unclear. The question is whether the transaction is reported as wages to an employee on a W-2, or has the option’s exercise converted the compensation to a guaranteed payment reportable to the new member on Schedule K-1? As previously noted, Reg. 1.721-1(b) requires that a capital interest conveyed in exchange for services is a Section 707(c) payment to a partner and is deductible by the partnership. With this in mind, it seems that immediately on exercising the option, the employee terminates employment status and becomes an LLC member.

The value of the LLC interest relative to the option’s strike price needs to be closely examined. If the option at the time of grant is “deep in the money,” it is possible that the LLC could be deemed to have issued additional LLC interests to a member in return for services. This would occur where the option price is so attractive that there is no doubt that the option will be exercised. In this situation, the LLC does not recognize any income on the grant of the option but the holder of the option would have income immediately with a compensation deduction available to the LLC.

Incentive Stock Options
Under Section 421, an employee can receive a qualified option to purchase stock without recognizing income when the option is exercised. As long as certain holding periods are met, only capital gain need be recognized on the disposition of the underlying stock. By definition, the intended benefits of an incentive stock option are limited to employees of corporate employers. Therefore, the incentive stock option is not available as a compensation technique for LLCs.

Corporate Member Stock
Can an employee or member of an LLC be compensated by a corporate member through the use of its stock? C corporations can compensate employees with parent corporation stock without recognizing gain on the FMV of such stock. For an LLC employee, the consequences can be very complicated. At best, it likely will result in a fully taxable event to all parties, nowhere near the convenient methods available to C corporations and their affiliates. For example, a corporate member could contribute its own stock to the LLC tax free under Section 721(a). A zero-basis carryover likely would apply to the contributed stock, however, and on disposing of it to the employee as compensation, gain to the extent of the stock’s FMV likely would be allocated back to the corporate member under the Section 704(c) contributed property rules. The employee would recognize ordinary income equal to the FMV of the stock, and the compensation deduction would be shared among the members according to the operating agreement. Furthermore, such compensation to members of an LLC could result in similar tax consequences, but in the form of guaranteed payments, or potentially could be recast under Section 731(c) as distributions of marketable securities to a member. If the FMV of the securities exceeds the distributee member’s basis, Section 731 gain could be triggered to the recipient. Consequently, compensating an LLC employee or employee-member with a corporate member’s stock is less appealing from a tax standpoint than other methods of compensating such individuals.

Arrangements Keyed to Appreciation
LLCs may find it more appropriate to use share appreciation methods to compensate key employees, which would not cause employees to give up their employee status. Employee-members of an LLC can also be compensated through the use of these nonequity appreciation arrangements, with payments under these arrangements likely to be treated as guaranteed payments under Section 707(c). Such arrangements may be based on the equity value of the LLC and appreci-
compared with stock appreciation in its shares, and can be compared with stock appreciation rights and phantom stock found in a corporate setting.

These appreciation-based compensation arrangements can be accomplished in a wide variety of ways, including variations on share appreciation rights (SARs) and phantom shares. Appreciation-based incentive compensation typically does not convey any actual equity interest or rights of control in the LLC. Although slightly different in structure, both SARs and phantom shares have common tax characteristics. For example, both are contractual compensation agreements granted in conjunction with the performance of services. Since there is no actual property promised or conveyed, Section 83 is inapplicable to the granting or exercising of SARs or phantom shares.

A common trait shared by these arrangements is the potential complexity presented by the valuation method used to measure share “appreciation.” Typically, the LLC interests are not traded on an open market, and do not have a readily ascertainable FMV. It is recommended that an objective formula be established up front to eliminate potential disagreement and disappointment by the compensated key employee.

Share appreciation rights. Under a straightforward SAR arrangement, an employee or member would be granted a number of shares. Typically, the value of these shares will coincide with the share value of the LLC on the grant date. On exercise, the employee or member is paid the difference between the value at the issue date and the value at the exercise date.

Example. The LLC may grant 100 SARs to a member when the shares of the LLC are worth $100. After one year, the member has the right to exercise the SARs at any time if still providing services to the LLC. Two years later, the member exercises the 100 SARs when the LLC shares are worth $200 each, and is paid $10,000 of compensation under the agreement. This payment would be deductible to the LLC when paid and included in the employee’s compensation or member’s guaranteed payment.

The IRS has ruled that, although the SAR may have current value to the employee or member before the exercise date, the rules of imputed income and constructive receipt do not apply. The general argument for exclusion from the imputed income and constructive receipt rules is that holders of SARs must surrender a valuable economic right if they choose to exercise. IRS has reasoned that the employee, who does not receive the full value of the underlying share, could not take the compensation received and invest it in a comparable investment.

Phantom shares. Phantom shares are typically granted at full value with both exercise restrictions and no ability to realize appreciation when exercised.

Example. An LLC issues 100 phantom shares with a value of $100 each to a key member, who can exercise them only after one year from the date of grant if still a member. One year later, all restrictions lapse and the member exercises the phantom shares when the shares are worth $200 each. The LLC pays the member $20,000 in compensation.

In contrast to SARs, the IRS has held that phantom shares generally will be subject to the rules of constructive receipt and imputed income. Since the phantom shares have value at the grant date, the member will be deemed to have received income on the earliest lapse of any restrictions to such shares. In the above example, the individual would recognize $20,000 of income on the lapse of the restriction after one year, whether the shares are exercised or not. The income to the member consists of the value at the grant date and all appreciation up to the date on which the member has a right to exercise. LLCs should anticipate such potential consequences of their compensation arrangements, and plan for the ability to provide cash to the member on the lapse of restrictions in anticipation of the compensated individual’s related tax liability.

Performance shares. Performance shares are another method of providing incentive compensation to key employees. These are generally different from equity-based compensation like SARs and phantom shares, and are based on an unlimited number of business aspects such as individual productivity or divisional productivity. This flexibility makes performance shares a more focused method of compensating for desired productiv-
ty. Nonetheless, performance shares require closer consideration before implementation to ensure that there is a correlation between the desired results and the base for performance share compensation. The IRS has held in Ltr. Rul. 8831028 that performance share arrangements may result in imput ed income and constructive receipt depending on the facts and circumstances or conditions of the agreement. For example, if the total compensation payable under the agreement has a cap amount that is reached and no restrictions on exercisability remain, the amount likely will be deemed paid.

**Golden Parachutes and Excessive Employee Remuneration**

Two limitations on the deductibility of compensation paid by C corporations to their executives (as well as a related excise tax) do not apply to LLCs. Nevertheless, executive compensation in an LLC is likely to be limited for tax purposes by a reasonable compensation standard.

Section 162(m) limits a publicly traded C corporation to a deduction of $1 million per individual for compensation paid to the five highest-compensated executives. The employer will never recognize a tax benefit for the excess. Even a publicly traded LLC, on the other hand, is not arbitrarily limited in deducting executive compensation.

Parachute payments are another type of compensation arrangements that grew in popularity during the acquisition-minded 1980s. Congress recognized that there was some virtue in allowing severance packages that provided economic security to executives, so that their attention was not necessarily distracted when the corporation was likely to need their leadership more than ever. Excessive arrangements were potentially problematic, however, because they ultimately could constrict the free interchange of businesses. Thus, Section 280G(a) bars the deduction of any "excess parachute payment" by a C corporation to a disqualified individual. Such payments are the amount that exceeds the five-year average compensation of an individual, if the net present value of the parachute payment is at least three times the average compensation. In addition to disallowing the deduction, Section 4999 requires that the executive pay a 20% excise tax on the excess amount. It is readily apparent that such parachute payments entail a significant cost to both the corporation and the individual receiving such payments.

Although LLCs and their executives are not subject to these provisions, it is likely that extraordinary compensation arrangements or payments could be challenged and recharacterized if the IRS believes that they are unreasonable. For example, if the executive is also a member of the LLC, the excess amounts could be recharacterized as a distribution or a Section 704 allocation of partnership income.

**Retirement Payments to a Member**

Sooner or later, like their peers in the corporate world, LLC members will want to retire or change jobs. In a corporate setting, there is little tax consequence to a corporate executive's departure. Maybe the executive's stock will be redeemed pursuant to a buy-sell arrangement, triggering capital gains to the executive that will not be subject to employment taxes. The redemption payments by the corporation will have no effect on the corporation's basis in its assets.

The withdrawal of an LLC member is not as straightforward. Various methods of accomplishing a member's withdrawal are available to the LLC, including provisions in the operating agreement, "employment" contracts, and cross-purchase agreements. When the retirement or withdrawal of a member is made through payments from the LLC, the character of income to the recipient and deductibility by the LLC will depend on the application of the rules provided under Section 736.

Section 736(b) provides the general rule that payments made to a retiring or withdrawing partner are to be considered a distribution by the partnership in exchange for the interest of such partner in the partnership property. The retiring member will recognize capital gain income to the extent the payment exceeds his basis in the LLC interest. The gain is taxed at the lower 28% capital gain rate and no part of the payment will be earned income subject to self-employment taxes. Consistent with this exchange

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47 For more on the Section 162(m) rules, see Sollee, "Ensuring Deductions for Performance-Based Compensation in Excess of $1 Million," 84 J. Tax'n 360 (June 1996).

48 Section 280G(b)(4) provides that a parachute payment does not include an amount that the taxpayer can establish, by clear and convincing evidence, is reasonable compensation. Section 280G(b)(5) provides that, in general, the parachute payment provisions do not apply to small business corporations (5 corporations or closely held corporations that could be 5 corporations but for a nonresident alien shareholder). Section 280G(b)(6) provides that payments from a qualified plan are not included in parachute payments.
treatment, the LLC receives no current deduction for the payment. In fact, the LLC derives no future benefits from the member's withdrawal unless a Section 754 election is made to increase the basis of LLC assets under Section 734(b). The Section 754 election is an advantage enjoyed by the LLC over its corporate counterpart because the election allows the LLC's assets to be stepped up generally by the gain recognized by the withdrawing member. This gives the LLC a net present value benefit based on future amortization of stepped-up LLC assets when a member withdraws and the Section 754 election is made.49

Section 736(a) provides a special rule that, except as otherwise provided under Section 736(b) (the general rule), payments made in liquidation of a partner's interest will be either a distributive share of partnership income (if determined with regard to partnership income) or a Section 707(c) guaranteed payment. For example, payments for unrealized receivables and goodwill can come under the purview of Section 736(a). Under Section 736(a), the withdrawing member will recognize the payment as ordinary income, and the LLC will take an equivalent deduction. As ordinary income, this amount also will be self-

49 For a more detailed look at Section 754, see Hollingsworth, "The Optional Basis Adjustment Provides Another Tax Planning Advantage for LLCs," 2 JLLC 114 (Winter 1995).
only if (1) capital is not a material income-producing factor for the partnership and (2) the retiring or deceased partner was a general partner in the partnership. This rule is generally focused on service partnerships. Often, today’s LLCs will not meet the requirements to exclude certain LLC property from the application of Section 736(b) (capital gain treatment but no entity-level deduction). Currently there is no direct guidance on whether an LLC member will be treated as a general partner for purposes of Section 736(b)(3)(B). If the rather liberal definitions of general partner applied to LLC members in Prop. Reg. 1.1402-18 apply here, it is likely that a full-time service-member of an LLC could be a general partner for purposes of Section 736(b)(3)(B). Presuming that the service-member is engaged in a business where capital is not a material income-producing factor, the special rules would apply.

Compared with the withdrawal of a corporate executive, the withdrawal of an LLC member can be quite complex. Although the tax benefits in certain LLC situations might be better because of the LLC’s flexibility, the ability to apply various alternative treatments to a member’s withdrawal payments only adds to the sophistication needed to deal with the LLC member. The magnitude of any tax consequences to the LLC, its remaining members, and the retiring member are fully dependent on the facts and circumstances. LLCs should undertake early planning for the withdrawal or retirement of a member, considering the global consequences in order to provide the best results for all parties. This should include the respective tax rates of the various parties, the character and timing of income or deductions, and the appropriateness of a Section 754 election for the LLC.

**LLC Retirement Benefit Plans**

The qualified retirement plan options available to LLCs are identical to those for corporations, with which most people are familiar. A defined benefit plan provides a certain benefit on retirement under a formula based on years of service and wages. A defined contribution plan provides for employer or employee contributions with credited earnings that build up in an account. A variety of plan arrangements are available based on these fundamental types, including cash balance plans, target benefit plans, money purchase plans, stock bonus plans, and employee stock ownership plans. Historically, partnerships involved in professional services have most prevalently offered defined contribution plans such as Section 401(k) plans, or profit sharing plans. Flexibility is the primary motivation for choosing such plans.

**Requirements for qualification.** Generally, the qualification requirements that apply to obtain tax-favored treatment of retirement plans apply to plans of self-employed individuals and LLCs. These qualification requirements include rules governing coverage and nondiscrimination, eligibility and minimum participation, service crediting, vesting, limitations on contributions and benefits, survivor benefits, and plan distributions. In addition, pension plans (defined benefit plans and money purchase plans) must satisfy minimum funding requirements. Moreover, several special considerations apply to plans covering self-employed individuals (and thus LLC members) are treated as employees for purposes of the qualified retirement plans rules but only to the extent that there is earned income. Section 401(c)(3) defines an “owner-employee” as a partner (and therefore LLC member) that owns a greater than 10% interest in partnership capital or profits. The qualification requirements for LLC plans that cover owner-employees include several special rules:

- **Aggregation rules (Section 401(d)(1)).** A plan that provides benefits for owner-employees must be aggregated for qualification purposes with plans in other trades or businesses if the owner-employees, or group of owner-employees, own more than 50% of all such trades or businesses.

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80 See also Collins and Dance, “Treatment of Liquidating Payments to LLC Members: How Will Section 736 Be Applied to LLCs?,” 2 JLLC 51 (Fall 1995).

81 “Earned income” is a term of art defined under Section 401(c)(2) with reference to net earnings defined in Section 1402. In general, the definition of earned income used to determine the maximum amount a self-employed individual can deduct for a contribution to a defined contribution plan is adjusted by subtracting deductible plan contributions made on his or her behalf as well as one-half of self-employment (SECA) taxes. This is a circular calculation that is cumbersome and can have significant consequences.
• **Comparability rules** (Section 401(d)(2)). A qualified plan cannot provide benefits to an owner-employee, or group of owner-employees unless the employees of each such trade or business are covered under a qualified plan providing benefits that are not less favorable than the benefits provided to employee-owners.

• **Contribution limitations** (Section 401(d)(3)). Under the plan, contributions on behalf of any owner-employee may be made only with respect to that owner-employee's earned income which is derived from the trade or business with respect to which such plan is established.

These additional limitations and requirements impose restrictions on partnerships and LLCs that are not applicable to trades or businesses operated as S or C corporations. (The aggregation and comparability rules would be repealed under pending pension simplification legislation.) The owner-employee restrictions will not apply, however, where the only members providing services to the LLC hold 10%-or-less interests.

Self-employed individuals and LLC members are subject to special deduction limitations. In addition to the general limits under Sections 404(a)(1), (2), and (3), Section 404(a)(8)(C) imposes two other limitations on the deductibility of contributed amounts. First, the deductible amount is limited to an amount that does not exceed the earned income of such individual derived from the trade or business for which the plan is established.

This prevents the LLC member from sheltering income derived from other sources. Second, the deductible amount does not include an allocable portion of contributions paid to purchase life, accident, health, or other insurance. This coordinates with other LLC-member provisions, referred to previously, that prevent the LLC member from excluding insurance from income-type fringe benefits.

Distributions from qualified plans may be eligible for favorable tax treatment. Most distributions from qualified plans (other than certain minimum required distributions, annuity payments, and corrective distributions) may be rolled over to another qualified plan or IRA. There are no special restrictions on rollover treatment for self-employed individuals. Five-year forward averaging treatment is generally available for a lump-sum distribution made because of certain triggering events, such as death, the attainment of age 59½, separation from service, or disability. Separation from service, however, is not a valid triggering event for a self-employed individual, and disability is a valid triggering event only for self-employed individuals. Thus, self-employed individuals generally will be eligible for averaging treatment only on the attainment of age 59½; or on disability.

Many retirement benefit plans allow participant loans. Loans to an owner-employee or a relative (spouse, brothers, sisters, ancestors, and lineal descendants) are not exempted from the prohibited transaction provisions of ERISA or the excise taxes under Section 4975. Without an exemption, such loans also could violate the qualification rules as an impermissible plan distribution.\(^52\)

Rules applicable to an LLC Section 401(k) plan. A few special rules apply to Section 401(k) plans maintained by LLCs (and partnerships). The most significant is Reg. 1.401(k)-1(a)(6)(iii), which provides that if an LLC makes matching contributions with respect to an individual member's elective contributions (or after-tax contributions), the matching contributions are treated as elective contributions made on behalf of the member. Thus, such matching contributions would have to be included in the actual deferral percentage (ADP) test rather than the actual contribution percentage (ACP) test that normally applies to matching contributions. Since such inclusion makes passage of the ADP test difficult at best, most partnerships and, presumably, LLCs would not make matching contributions on behalf of members. To make up for this disadvantage, some organizations look to a nonqualified deferred compensation arrangement.

**Conclusion**

The LLC form of doing business, although complex in many respects, allows businesses incredible flexibility in compensating employees, key managers, and members providing services. Corporate executives familiar with the common everyday employer-employee relationship will need to be informed and guided through the compensation differences and complexities that LLC membership

\(^{52}\) Section 4975(d); ERISA Section 408(d).
presents. The most significant of these differences are (1) the taxability of certain fringe benefits, (2) diminished benefits from deferred compensation due to offsetting increases in distributive share of LLC income, (3) potential taxable gains on appreciation in LLC assets on admissions of new members or the issuance of additional interests to existing members in return for services, and (4) alternative approaches to withdrawal payments to LLC members. Unquestionably, compensating the LLC service-member is a strange new world for many practitioners who take the corporate employment environment for granted. Alas, it is also a world with which all practitioners will have to become familiar as the LLC becomes ever more popular in the future.