

LIMITED LIABILITY COMPANY (LLC)

Beginning with Wyoming in 1977, every state and the District of Columbia now have adopted laws authorizing the creation of LLCs in varied forms. Generally, the LLC is seen as a hybrid between a corporation and a general partnership. It is taxed and governed similarly to a partnership, but offers limited liability for the owners ("members") similar to that offered by a corporation. The LLC often is preferred over the "S" corporation because the latter is subject to many more operational restrictions.

Since the LLC is not quite a corporation, but involves more than a partnership, a question arises as to the proper treatment of payments to LLC members for services to, or on behalf of, the LLC. For separate entities, such as corporations, a shareholder performing services for the corporation, generally is considered an employee for payroll tax purposes. However, partners in a partnership would not be treated as employees.

While the Internal Revenue Code does not specifically recognize LLCs, IRS Regulations do recognize them as "eligible entities." As an "eligible entity," an LLC may make the election to be treated as a corporation, even though unincorporated and not subject to the usual standards designating when an unincorporated entity may be treated as a corporation. An "eligible entity," including an LLC, which has two or more members and was formed after 1996, is classified as a partnership for Federal tax purposes UNLESS it elects to be treated as an association taxable as a corporation. (The election is made by filing Form 8832, *Entity Classification Election*.) Absent the election, the members of such an LLC "partnership" are not employees, and generally are subject to Self-Employment Tax on their earnings from the "partnership."

If an LLC is treated as a corporation, members of the LLC will be treated as if they were shareholder/employees of the corporation for payroll tax purposes. The member is subject to withholding on payments for services to the LLC and would receive a Form W-2 for such payments. Distributions of the remaining LLC earnings and profits to members are treated as dividends.

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EMPLOYEE vs. INDEPENDENT CONTRACTOR

When a worker performs services and receives some form of remuneration, an important question is whether the remuneration is subject to employment taxes. The answer depends on whether the worker is an employee or an independent contractor. This determination of the worker's status depends on the facts . . . facts which define the business and the relationship of the parties, at the time the services are rendered.

Generally, a common law EMPLOYEE works for and performs services under the control of the party which pays for the services. On the other hand, an INDEPENDENT CONTRACTOR is an individual in business for himself or herself, and performs the services free of control from the party which pays for the services.

Employment taxes apply solely to the remuneration paid to workers classified as EMPLOYEES. The employer's obligation is to deduct Federal income tax withholding (FITW), to deduct as well as "match" Social Security and Medicare taxes (FICA), and to pay Federal unemployment tax (FUTA). Also, there may be state income tax to be withheld and the employer or employee may have to pay state unemployment compensation contributions and state disability insurance. A business normally is not required to withhold taxes from payments made to independent contractors.

In addition, certain Federal and state laws governing benefit-plan participation, wage payment, working conditions and workers' compensation, apply ONLY to employees and not to independent contractors. For example, only employees may participate in a Section 401(k) pension plan, and only employees are protected by minimum wage and overtime pay laws.

I.R.S. Guidance

When determining under common law whether an individual is an employee or an independent contractor, the I.R.S. stresses that ALL evidence of the degree of control and degree of independence must be considered. Formerly, the I.R.S. used a list of 20 factors (the "20-Factors Test") to evaluate a specific worker's situation. The current I.R.S. official guidance, however, in Publication 15-A, *Employer's Supplemental Tax Guide -- Supplement to Circular E*, indicates that facts which provide evidence of the degree of control and independence fall into three major categories: behavioral control, financial control, and the type of relationship between the parties, as follows:

a.) BEHAVIORAL CONTROL Facts that show whether the business has the right to direct and control how the worker does the task for which the worker is hired, include the type and degree of:

--**instructions the business gives the worker**. An employee is generally subject to the business' instructions about when, where and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the RIGHT to control how the work is done.

--**training the business gives to the worker**. An employee may be trained to perform services in a particular manner. Independent contractors, however, ordinarily use their own methods.

b.) FINANCIAL CONTROL Facts that show whether the business has a right to control the business aspects of the worker's job, include:

--**the extent to which the worker has un-reimbursed business expenses**. Independent contractors are more likely to have unreimbursed expenses than employees.

--**the extent of the worker's investment**. An independent contractor often has a significant investment in the "facilities" used to perform services for someone else, but this is not mandatory.

--**the extent to which the worker makes services available to the relevant market**. Employees tend to work for a single business.

--**how the business pays the worker**. An employee generally is paid by the hour, week or month. An independent contractor usually is paid by the job. However, it is common in some professions, such as law, to pay independent contractors at an hourly rate.

--**the extent to which the worker can realize a profit or incur a loss**. An independent contractor can make a profit or loss.

c.) TYPE OF RELATIONSHIP Facts that show the type of relationship between the parties, include:

--written contracts describing the type of relationship the parties intended to create

--whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.

--the permanency of the relationship. If one engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence the intent was to create an employer-employee relationship.

--the extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of the company's business activity, it is more likely that the company will have the right to direct and control his or her activities. This would indicate an employer-employee relationship.

Upon request, the I.R.S. will determine whether a worker is an employee. File Form SS-8 (*Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*). Note that some special rules apply when determining whether salespersons are common law employees. Also, some state unemployment compensation programs define "independent contractor" more narrowly than the I.R.S.

Applying the Rules: I.R.S. Offers Specific Examples

EXAMPLE 1.) An electrician submits a job estimate to a housing complex for electrical work at \$16 per hour for 400 hours. The electrician is to receive \$1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if the electrician works more or less than 400 hours to complete the work, \$6,400 will be received. Meanwhile, the electrician is performing additional installations under contracts with other companies, which are obtained through advertisements. *This electrician is an independent contractor.*

EXAMPLE 2.) An auto sales agency furnishes space to a mechanic who performs auto repair services. The mechanic provides his own tools, equipment and supplies. He seeks out business from insurance adjusters and other individuals and does all the body and paint work that comes to the agency. The mechanic hires and discharges his own helpers, determines his own and the helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives (as compensation for his services) a large percentage of the gross collections from the auto repair shop. *The mechanic is an independent contractor and the helpers are his employees.*

EXAMPLE 3.) An auto sales company has an auto repair department in which Sam works as an auto mechanic. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts and supplies. The company also issues instructions on the amounts to be charged, parts to be used and the time for completion of each job, as well as checking all estimates and repair orders. *Sam is an employee of the sales company.*

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**WAGES PAID TO FAMILY MEMBERS
MAY BE EXEMPT FROM
FICA AND FUTA TAXES**

When an employee is the son or daughter, spouse or parent of the employer, there are situations when special employment tax rules will apply.

Federal income tax withholding, however, is the same for relatives of the employer as it is for other employees. If the relative is an employee under the common-law test, then the usual federal income tax withholding applies to the wages paid.

The requirements for social security and Medicare taxes, however, depend on the age and type of work performed by the particular family member:

a.) **SPOUSE** - The usual social security and Medicare tax withholding applies to the wages paid to the spouse of the employer, unless the spouse's services are *not* performed in the course of the employer's trade or business, or are for domestic service in the employer's home. In either of these situations, the wages paid would be exempt. Note, however, that this exemption does not apply to wages paid to the spouse by a corporation, partnership or an estate.

b.) **SON or DAUGHTER** - If the child is under age 18, wages paid by the parent are exempt from social security and Medicare tax withholding. However, if the child is 18 years or older but under age 21, wages paid by the parent are exempt only if the services are not in the course of the employer's trade or business. For these purposes, "child" includes adopted children, as well as foster children and stepchildren. As with the spouse, the exemption does not apply if the services are performed for a corporation (even if it is controlled by the child's parent), partnership (unless each partner is a parent of the child), or an estate.

c.) **PARENT** - Where the employer is the son or daughter, any wages paid to the parent are subject to social security or Medicare taxes, unless the services being compensated are not in the course of the son or daughter's trade or business, or are domestic service performed in the employer's home.

However, domestic service in the employer's home might NOT be EXEMPT in the following circumstances: A parent caring for a child living with the son or daughter (employer), if the child is less than age 18 or has a mental or physical condition requiring adult supervision for at least four continuous weeks in a calendar quarter. In these situations, there is no exemption if the son or daughter (employer) is widowed or divorced (and not re-married), or has a disabled spouse who is unable to care for the child due to physical or mental inability.

For federal unemployment tax (FUTA), if the employee is the spouse or parent of the employer, wages paid are exempt from FUTA. Likewise, if the employee is a son or daughter of the employer, and is under age 21, the wages paid are exempt from FUTA. However, if the employer is a corporation, a partnership (unless each partner is a parent of the child), or an estate, the FUTA exemption does not apply. As with the FICA exemption, "child" for the FUTA exemption includes a foster child, a stepchild or an adopted child, under age 21. It also includes employees who are foster parents or stepparents working for their children.

Finally, it is interesting to note that family businesses where the only regular employees are members of the owner's immediate family, are excluded from coverage by the Fair Labor Standards Act (FLSA). "Immediate" family means a parent, spouse or child. For the exemption from FLSA to apply, non-family workers may be employed only in occasional instances. If exempt from FLSA, then the federal minimum wage rate, overtime pay and other workplace standards imposed by the FLSA do not apply.

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