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Potential revisions to self employment regulations could be costly to real estate professionals

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Real estate professionals conduct their businesses from various types of entities or arrangements. Perhaps the most popular of these is the Limited Liability Company, or LLC. Members of LLC's enjoy protection from personal liability for the LLC's debts, as well as limiting losses to a member's investment in the LLC.

LLCs have the option of electing how to be taxed at the federal level: either as a partnership or as a corporation. For LLCs who elect partnership tax treatment, members are generally treated as limited partners. The tax benefit to real estate professionals occurs when income that would be classified as passive for limited partners, is classified as non-passive. Therefore, losses sustained by real estate activities can offset other types of ordinary income.

A more valuable tax attribute of the LLC is a member's distributive share of income is not classified as self-employment income.

Three recent court decisions, Garnett, Thompson, and Gregg, have caused the IRS and Congress to reconsider the regulations concerning LLCs in relation to the material participation tests for real estate professionals to determine if LLC members could potentially be subject to self-employment taxes.

The code sections, regulations, and other legal cites of the above cases are beyond the scope of this article, but the IRS' contention that if some members materially participate in the management of the LLC, they are performing duties more associated with those of a general partner, whose distributive share of income is subject to self-employment tax.

At the present time, the IRS position regarding LLC members and self-employment taxes has not been revised, but with Congress considering any method to raise revenues, there is a strong likelihood that revisions to the passive activity rules and regulations will be enacted, affecting many business entities and plans designed to take advantage of the tax benefits currently enjoyed by real estate professionals.

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