NEW YORK STATE BAR ASSOCIATION
TAX SECTION

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SUMMARY AND INTRODUCTION

Section 1401 of the Code imposes a two-tier tax on self-employment income of individuals, referred to as the Self-Employment Contributions Act ("SECA") tax. The old age, survivors and disability insurance portion of the tax is levied at the rate of 12.4% of such income, and under Section 1402(b) is capped at the same level as social security taxes are (currently $90,000 of self-employment income). The hospital insurance (Medicare) portion of the tax is levied at the rate of 2.9% and is uncapped. Individuals are allowed to deduct one-half of their self-employment tax in calculating adjusted taxable income subject to the regular income tax, as a means of achieving rough parity with the manner in which employees are taxed.

Under Section 1402(a) of the Code, an individual's net earnings from self-employment ("NESE") subject to self-employment taxes under SECA generally include his distributive share of bottom-line income (or loss) from any trade or business carried on by a partnership of which he is a partner. An exception to that rule, contained in Section 1402(a)(13), excludes from NESE the distributive share of a "limited partner, as

[1] The principal drafters of this report were Kimberly S. Blanchard and Andrew Kreisberg. Helpful comments were received from Patrick Gallagher, David Hariton, Stephen Land, Richard Loengard, David Miller and Michael Schler.

such" (other than guaranteed payments for services). Because these rules speak in terms of "partners" and "limited partners," questions have arisen over how to apply these rules to members of LLCs and other pass-through entities who are treated as partners for tax purposes but who are not clearly "general" or "limited" partners.

On January 29, 2005, the Joint Committee on Taxation (the "JCT") published a report entitled, "Options to Improve Tax Compliance and Reform Tax Expenditures." Part IIIF of the JCT's report generally proposes that legislation be enacted to subject any partner or member of a pass-through entity who materially participates in the entity's business, as well as any S corporation shareholder who so participates, to self-employment taxes on such individual's share of the bottom-line income of the entity (the "JCT Proposal"). In effect, the JCT Proposal would extend Section 1402(a) to any owner of a pass-through entity who materially participates in the entity's business.

We commend the JCT for proposing legislation to address an issue that, as explained below, has frustrated the Treasury's attempts to deal with by regulations. On December 9, 1994, we filed comments on the appropriate treatment of owners in pass-through entities for the purposes of the self-employment tax, an issue that had been considered in connection with certain legislative proposals presented to Congress in that year (the "Health Care Report"). None of those proposals was enacted into law. Then, on December 29, 1994, the Treasury Department issued proposed regulations addressing the issues posed by applying the literal language of Section 1402(a)(13) to members of LLCs (the "1994 Proposals"). We commented on the 1994 Proposals ("Comments on Proposed Regulations Relating to Self-Employment Tax Treatment of LLC Members,"

November 16, 1995; hereafter, the "1995 Report"). On January 10, 1997, the Treasury Department replaced the 1994 Proposals with a new notice of proposed rulemaking, defining a limited partner for purposes of the self-employment tax rules (the "1997 Proposals"). We also commented on the 1997 Proposals ("Comments on Proposed Regulations Relating to Definition of Limited Partner for Self-Employment Tax Purposes," March 11, 1997; hereafter, the "1997 Report").

After our 1997 Report was submitted, Congress responded to taxpayer complaints about the scope of the 1997 Proposals by imposing a moratorium on regulations regarding employment taxes of limited partners.[2] The Act provided that no such regulations could be issued or effective before July 1, 1998. No regulations have been proposed or finalized since the moratorium was issued.

Although each of the foregoing proposals was somewhat different in scope, a consistent theme has been the attempt to conform to a greater or lesser degree the employment taxation of similarly-situated individuals. The Tax Section of the New York State Bar Association has uniformly supported these proposals. The problem is that the Code contains very different rules for "general" and "limited" partners, and those rules no longer reflect the realities of how business is conducted through various types of entities. The adoption of a single consistent rule applicable to all owners of pass-through entities would, as the JCT notes, enhance horizontal equity and discourage tax-motivated choices among different business forms.

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[2] Taxpayer Relief Act of 1997, P.L. 105-34, § 935, 105th Cong., 1st Sess. (1997). Some very vocal taxpayer groups complained that the 1997 Proposals amounted to a "stealth tax" imposed by the Service. See, e.g., *Tax Bill Blocks Controversial Self-Employment Tax Regulations,"* 76 Tax Notes 752 (Aug. 11, 1997).

We strongly endorse the JCT's attempt to deal with this issue through legislation rather than through regulation. Because the problems sought to be addressed by the JCT Proposal are legislative in origin, they are best addressed by amending legislation. We agree with the JCT that these issues have been left unresolved for too long, frustrating the compliance efforts of taxpayers and the efforts of the Internal Revenue Service to provide meaningful guidance. We offer our comments on the JCT Proposal here.

A summary of our comments is as follows:

1) We have long supported, and continue to support, the application of a "material participation" test to distinguish between those owners of pass-through entities who should be subject to self-employment taxes on their distributive share of the entity's income from those who should be subject to tax only on reasonable compensation for services. The JCT Proposal helpfully expands the definition of material participation and aligns it with existing rules under Section 469. We offer a few technical suggestions on this portion of the JCT Proposal.

2) Once the appropriate universe of persons subject to tax on distributive share income has been identified by application of the material participation test, we believe, and have consistently advocated, that the tax base should be narrowed in order to bifurcate income from labor and income from capital, treating only the former as NESE. The JCT Proposal considered but rejected such a narrowing. For the reasons described more fully below, we believe that the JCT Proposal goes too far in the direction of extending self-employment taxes to income from capital, as opposed to income from

labor, thereby widening the gap in treatment between otherwise similarly-situated employees and self-employed persons.

3) For the reasons described below, we also disagree with the portion of the JCT Proposal that would repeal the current exemptions from NESE for items of generally passive income (such as dividends and interest) in the case of enumerated types of service partnerships.

4) We generally support the JCT Proposal's extension to shareholders of S corporations of the same rules applicable to owners of other pass-through entities, but note some of the practical issues entailed by so doing.

BACKGROUND

1. The Statutory Problem.

The general rule of Section 1402(a) defines NESE to include an individual's distributive share of income derived from any trade or business carried on by a partnership of which he is a member. Enumerated paragraphs of Section 1402(a) exclude from NESE a variety of items of income, generally passive in nature. These rules have their origin in pre-1954 versions of the Code.

Section 1402(a)(13) is an exception to the general rule applicable to partners. It excludes from NESE the distributive share of any "limited partner, as such" other than Section 707(c) guaranteed payments for services actually rendered (analogous to wages earned by an employee). Section 1402(a)(13) was enacted in 1977 to reverse the result in Estate of Ellsasser, 61 T.C. 241 (1973) , in which the Tax Court held that a limited, inactive partner of a brokerage partnership was subject to SECA on his distributive share of the partnership's bottom-line income. As noted in the Ellsasser

decision, when Section 1402(a) was originally added to the Code in 1949, Congress specifically stated its intent that SECA should apply to "limited or inactive" partners.[3] In 1977, Congress changed its mind, exempting limited partners from the scope of Section 1402(a)'s general rule.

The Section 1402(a)(13) exception was enacted at a time when state partnership laws required limited partners to be almost entirely passive investors. In the 1977 legislative history, Congress stated its concern that purely passive limited partners were attempting to come within the Social Security system by virtue of Section 1402(a)'s general rule. Congress made clear that the provision was intended to distinguish "income from an investment" and "earnings from work."[4]

In the ensuing years, the states increasingly adopted revisions to their limited partnership acts permitting limited partners to take on somewhat more active roles without losing limited liability. More recently, all fifty states adopted LLC legislation (and many have adopted LLP and LLLP legislation) creating entities in which no member is a "limited partner, as such." Finally, the "check-the-box" entity classification rules promulgated in 1996 undercut the income tax significance of state-law distinctions between general partners, limited partners, LLC managers and LLC members. All of

[3] H. Rep. 1300, 81st Cong., 1st Sess. 136-137 (1949).

[4] "Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work." H.R. Rep. No. 702, Part I, 95th Cong., 1st Sess. 40-41 (1977).

these developments put great pressure on Section 1402(a)'s statutory language and underlying assumptions.

2. Earlier Proposals.

The legislation addressed in our Health Care Report would have amended Section 1402 to address the treatment of owners of pass-through entities. Our Health Care Report supported the elimination of any distinction in the treatment of owners of the various types of pass-through entities.[5] However, we also unequivocally recommended eliminating the "per se" aspect of Section 1402(a) that treats the entire distributive share of a partnership's bottom-line income (with some exceptions) as NESE to a general partner. Our Health Care Report recommended that any NESE treatment should apply only to owners who rendered substantial services to the entity, and that in appropriate cases the interest of an owner should be bifurcated between that attributable to services and that attributable to capital.

The Health Care legislation was never enacted. The 1994 Proposals, which would have amended the regulations under Section 1402, addressed only the issues posed by applying the literal language of Section 1402(a)(13) - "limited partner, as such" - to members of LLCs. Proceeding from the assumption that LLC members who are also "managers" act in a capacity similar to that of a general partner, the 1994 Proposals excluded LLC managers from Section 1402(a)(13) limited partner status. Although our 1995 Report expressed dissatisfaction with the use of state-law criteria to determine

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[5] None of our prior reports addressed employment taxes under the Federal Insurance Contributions Act (FICA) applicable to S corporation shareholders, which until the JCT Proposal had not been the subject of any governmental proposal.

which members of pass-through entities must treat their distributive share income as NESE, we supported the 1994 Proposals' "manager rule," because it generally equated managing members of LLCs with general partners of partnerships and nonmanaging members of LLCs with limited partners of partnerships.

The 1997 Proposals replaced the 1994 Proposals and took a more comprehensive approach to the problem. The 1997 Proposals were motivated in part by the then-recent adoption of the "check-the-box" entity classification regulations, which significantly broadened the class of persons whose status under Section 1402 was uncertain. The 1997 Proposals attempted to distinguish between an LLC member treated as a "general" partner and one treated as a "limited" partner by a three-factor test that took into account not only material participation, but also state law factors. Our 1997 Report expressed concern over the attempt made in the 1997 Proposals to distinguish between general and limited partners based on traditional state-law notions of personal liability and agency. Those criteria, we argued, were irrelevant to the underlying inquiry for NESE purposes, which should be the extent to which a partner's distributive share represents earnings from work.[6] To that end, we supported the 1997 Proposals' material participation test, which we felt more directly addressed the issue, and suggested ways to expand that test.

The 1997 Proposals contained a special rule excluding service partners of service partnerships from limited partner status. The effect of that special rule would

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[6] One of the advantages of making changes to this area of law in the form of legislation rather than by regulation is the elimination of the artificial restraints created by the Service's need to fit its regulations within a cramped statutory construct (the "square peg, round hole" problem).

have been to treat service partners of service partnerships as materially participating in the partnership's business per se. One reason that we suggested expanding the material participation test was to obviate the need for the special service partner rule, which we felt created undue complexity without substantial policy justification.

The 1997 Proposals also attempted to bifurcate a partner's distributive share of partnership income into the portion attributable to earnings from work and treated as NESE, and some portion attributable to a return on capital, which would not be NESE. They did this by allowing service partners to "piggyback" upon the treatment accorded non-service (limited) partners. A class of interest issued to passive investors not materially participating in the business of the partnership would, in effect, have been treated as noncompensatory and if held by an active partner any income attributable to that interest would not have been subject to SECA.[7] Although we supported the attempt to bifurcate income from services from income on capital, we disagreed with this approach to bifurcation, which we felt was overly rigid and form-driven, and reiterated the approach taken in our Health Care Report, which would have allowed an owner to prove the extent to which his distributive share is a return on capital invested, with a safe harbor deemed rate of return on contributed capital.

None of the prior proposals would have affected the FICA treatment of S corporation shareholders. As noted in the background materials to the JCT Proposal, S corporation shareholders are taxed as employees and thus subject to FICA, rather than SECA, on compensation for services. No rule subjects an S corporation shareholder to

[7] See Prop. Reg. § 1.1402(a)-2(h)(3), (h)(4).

FICA on 100% of his distributive share of S corporation income. FICA applies only to compensation received from the S corporation for services. If the Service considers the amount paid to an S corporation shareholder for services to be artificially low, its remedy has been to challenge the allocation upon audit.

3. The JCT Proposal.

Subject to the material participation test described below, the JCT Proposal would generally apply Section 1402(a) to any owner of an interest in a pass-through entity, subjecting him to self-employment tax on his distributive share (whether or not distributed) of the entity's income or loss. Section 1402(a)(13) would be repealed, such that all partners of partnerships would be treated the same regardless of whether they were limited or general partners. As under present law, certain types of income or loss, such as certain rental income, dividends and interest, certain gains, and other items, would be excluded. However, partners of a service partnership and shareholders of a service S corporation would not entitled to these exclusions; 100% of their income from the partnership or S corporation would be treated as NESE. The JCT Proposal defines a service partnership as "a partnership, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2))."

The JCT Proposal contains an important exception to these general rules that is intended to narrow their scope. For any partner who does not materially participate in the trade or business of the partnership, a special rule would provide that only the partner's reasonable compensation is included in NESE. Material participation

would be defined by reference to the Section 469 regulations.[8] Significantly, the material participation test would apply to all partners, including general partners and members of service partnerships.

The JCT Proposal considered but explicitly rejected any provision for bifurcating income from services and capital.

The JCT Proposal treats S corporation shareholders in the same way that it treats partners. S corporation shareholders would be subject to self-employment tax on their shares of S corporation net income (whether or not distributed) or loss.[9] The same items of income or loss that are excluded from NESE for partners are excluded for S corporation shareholders, and, in the case of a service S corporation, these exclusions do not apply. A service S corporation is defined in the same way as a service partnership. Finally, an S corporation shareholder who does not materially participate in the S corporation's business is subject to the same special rule as a partner, whereby only reasonable compensation from the S corporation is treated as NESE.

DISCUSSION AND RECOMMENDATIONS

1. <u>In General</u>.

Section 1402(a) is premised on the notion that a general partner should be subject to SECA tax on his distributive share of a partnership's trade or business income. Under this approach, absent some exception, it is irrelevant whether a partner performs any services; the only relevant fact is whether the partnership conducts a trade or

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[8] See Treas. Reg. § 1.469-5; Temp. Reg. § 1.469-5T.

[9] The JCT Proposal assumed that if the SECA rules applied to active S corporation shareholders, such shareholders would become subject to the estimated tax regime.

business. In contrast, under Section 1402(a)(13) limited partners are subject to SECA only on guaranteed payments for services, and shareholders of S corporations are subject to FICA on reasonable compensation for any services, actually provided. The JCT wanted one regime to apply to all pass-through owners, both to foster horizontal equity and to prevent "gaming" of the rules. It followed that one of the first issues that the JCT Proposal had to address in conforming the taxation of partners and S corporation shareholders was whether to adopt the general partner or limited partner model.

The JCT Proposal chose the general partner model. It is clear that in doing so, the JCT was motivated primarily by the difficulty of enforcing the reasonable compensation rule. Having chosen the general partner model, the JCT then had to decide which expanded class of persons to apply it to. The JCT Proposal employs a material participation test to distinguish between those persons who are treated like current-law general partners, and those that are treated like current-law limited partners or S corporation shareholders.

2. The Material Participation Test.

We support the JCT's approach of using the material participation test, as defined in the Section 469 regulations, to distinguish between those individuals who are generally subject to SECA on their distributive share income and those who are subject to SECA only on reasonable compensation for services actually provided (although as noted we believe the base to which the tax applies should be narrowed considerably). We suggested the adoption of a material participation test for distinguishing between "general" and "limited" partners in our Health Care Report. The 1997 Proposals would have adopted such a test (among other tests), but the only criterion was whether a partner

worked for more than 500 hours during the year. In our 1997 Report, we recommended expanding the test. In addition to including participation for more than 500 hours during the year, we suggested the test include participation by an individual that constitutes substantially all of the participation in the entity's trade or business of all individuals during the year. We also suggested material participation could include participation for more than 100 hours during the year, if no other individual participates more than the taxpayer. By basing its definition of material participation on the Section 469 regulations, which include the aforementioned provisions, the JCT Proposal seems to have adopted these suggestions.

The material participation test as embodied in the Section 469 regulations should be adapted in several respects to be applied for purposes of SECA. For example, Treas. Reg. §§ 1.469-5T(a)(5) and 1.469-5T(a)(6) treat an owner as having materially participated in a given taxable year if he materially participated in an activity for a specified number of past years. We are uncertain about what the rationale for these rules was in the passive activity loss context, but in any case these rules do not seem to us suited to the circumstances of the SECA tax, which is a tax on income derived from actually working. For example, Section 1402(a)(10) provides an exception from the rule that a partner's distributive share of partnership income is NESE. Under that exception, a retired partner who renders ***no*** services to a partnership may generally exclude payments received on account of retirement. Adoption of a material participation test would appear to render the retired partner rule of Section 1402(a)(10) statutory surplusage, since a partner who renders no services cannot be said to be materially participating under any test. Under the JCT Proposal, a retired partner would be taxed only on any reasonable

compensation received from the partnership. We assume that Section 1402(a)(10) would be repealed as part of any enacted legislation, and that new rules would be provided addressing the circumstances under which "reasonable compensation" does or does not include retirement payments.

The material participation test would also need to be clarified insofar as it might apply to partners who were formerly employees. It is becoming increasingly common for businesses taxable as partnerships to provide common-law employees with incentive or "equity" compensation in the form of a restricted or profits interest in the partnership. While the question whether such an employee is a "partner" for tax purposes is beyond the scope of this report, to avoid confusion, the material participation test should provide that the "participation" in question must be in the individual's capacity as a partner.

3. Bifurcation of Labor from Capital Income.

The JCT Proposal rejected bifurcation and made no attempt to narrow the scope of Section 1402(a). In its report, the JCT, citing administrability concerns, rejected a bifurcation approach that would attempt to determine a reasonable return from capital, which would then be excluded from employment taxes. The JCT notes the difficulties of determining a reasonable rate of return from capital for any particular business, given that rates of return can vary significantly across different types of businesses, at different times in the life of a business, and with different management, among other factors. The JCT asserted that current law, which excludes readily identifiable capital income such as dividends, interest and rents from NESE, serves as an adequate proxy for true bifurcation.

The JCT acknowledged that its proposal would in any event require factual inquiries, first into whether an owner materially participates in the trade or business of the entity and if not, into what constitutes reasonable compensation. The JCT notes that the first inquiry would be undertaken under well-settled Section 469 regulations, and that the second would need to be made only when an individual does not materially participate in the trade or business, thus limiting the situations in which this problem arises. Nevertheless, because material participation serves as the sole limiting factor under the JCT Proposal, we believe that the issue will be frequently joined.

In its explanation of its proposal, the JCT does not appear to acknowledge the sweep of its proposed changes, and the degree to which its proposal would depart from current law. The broad rule of Section 1402(a) was adopted at a time when entities organized as partnerships with unlimited liability were generally limited to the service professions (indeed, we believe this is the reason for the special "service partnership" rule). Moreover, at that time both the old age and hospital insurance portions of the SECA tax were capped at relatively low levels. In that context, treating all of the entity's income, with the exception of enumerated passive receipts, as NESE was generally appropriate, was not unduly burdensome and was a simple rule to apply.

However, today many types of businesses are operated as pass-through entities. Because limited liability for owners is easy to achieve, even businesses with large amounts of capital at risk may operate in partnership form for tax purposes. For example, there are any number of closely-held or family businesses, organized as LLCs, that engage in such businesses as the manufacture and distribution of specialty foods, the manufacture and sale of windows, the development and sale of high-value software

applications, oil and gas extraction, or publishing. Many of these businesses are national or even global in scope, and many are extremely profitable. In any of these cases the majority of the earnings and value of the business will be attributable to sales, marketing, distribution, the efforts of non-owner employees, intangible assets and goodwill.

It is not uncommon for some owners to be materially involved in the business, and others to be uninvolved (e.g. family members who own their interests by reason of family connections). Under current law, the active owners would typically receive guaranteed payments or, if the entity is organized as an S corporation, salaries, that reflected the extra value they bring to the business. Under the JCT Proposal, an owner who materially participates in such a business would be subject to SECA, uncapped as to the hospital insurance portion, on virtually his entire distributive share of the entity's income, where another owner who does not participate would not be. The resulting discrepancy between the way active and passive owners are taxed could run to millions of dollars, having nothing to do with the value of the active owner's services. The material participation test is simply not a proxy for a rule that properly bifurcates a return on capital from labor income.

To subject the working owners of such businesses to SECA tax on virtually all the income of the business is to expand the application of the SECA regime well beyond its original scope and will invariably have the effect of imposing the SECA tax on income from capital.[10] Such a rule will drastically increase horizontal inequity,

[10] It is not an answer to say that under current law, a general partner of a partnership would suffer these same tax consequences. Under current law, the owners of a capital-intensive business who desire pass-through treatment would normally choose not to act as general partners; they would use an LLC or an S corporation, or they would use a limited

both between the owners of a single business and between self-employed and employed workers. While Congress certainly has the power so to expand SECA, it is unclear from reading the JCT Proposal whether the JCT fully appreciates the scope of that expansion. Moreover, we are not convinced that Congress would wish to expand SECA in this manner while continuing to permit employees of incorporated businesses to pay FICA tax on only reasonable compensation for services actually rendered, as such a step would obviously exacerbate concerns over treating similarly-situated individuals differently.

In fact, we are concerned that if the JCT Proposal were enacted in this form, taxpayers would resort to alternative structures to avoid SECA, probably successfully. Individuals might attempt to separate income from labor and income from capital in new ways. They might, for example, form a separate partnership to hold the capital property of an active trade or business and a separate C corporation through which the individuals provide services to the partnership. The C corporation might then pay out all of its income as salary and thereby avoid the self-employment tax.

For these reasons, we believe that in addition to the current exclusion from NESE for items of passive income, any new legislation should adopt some type of bifurcation rule designed to limit the SECA tax to a tax on income from work. The 1997 Proposals recognized the overbreadth of Section 1402(a) and attempted to narrow its scope by providing rules pursuant to which partners could bifurcate their distributive share of partnership income into a component attributable to labor and subject to SECA,

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partnership with an S corporation general partner having only a small interest in the partnership. The JCT Proposal would eliminate these planning techniques and thus greatly, even exponentially, expand the current scope of Section 1402(a).

and a component attributable to capital and exempt from SECA. Unfortunately, the proposed bifurcation approach was overly formalistic and rigid, requiring that a class of partnership interest be held by passive investors so as to create a "control" group. We believe that any bifurcation proposal should treat the owner of a single-member LLC no differently than the owners of a multiple-member pass-through entity. If this concern can be addressed, we think that the approach taken in the 1997 Proposals, with some modifications as noted in our 1997 Report, bear further study, as it was designed to be applied objectively.

There are a number of alternative approaches to achieving bifurcation. One approach would be to adopt a single, neutral principle of bifurcation that treats so much of any business owner's distributive share income that equals reasonable compensation for services as NESE, and everything over and above that amount as income from investment of capital. One advantage of this approach, in addition to its conceptual purity, is that it would conform the treatment of all owners of all pass-through entities without the need for the material participation filter. The principal disadvantage of this approach is that it is a subjective standard that by its nature is susceptible to abuse and difficult to enforce, as has apparently been the case under the current rule for S corporation owners. We supported this approach in our Health Care Report, our 1995 Report and our 1997 Report, but recognized that while such a formulation is easy to state and to understand, it may be difficult to apply in concrete cases.

Our prior reports have also supported excluding from NESE a safe harbor deemed rate of return on partnership capital. Such an approach would not present the problem, identified in the JCT Report, of having to determine a separate rate of return on

capital for different types of businesses. If a more tailored rule were desired, any new legislation adopted could instruct the Treasury Department to develop a series of tables, based on available government statistics, proscribing the percentage of income of various industries that should be treated as attributable to capital rather than to services.

In our Health Care Report and 1997 Report, we made several other suggestions for ways of approaching the bifurcation problem. These included coupling a safe harbor rate of return on capital with a rule allowing a business entity member to prove the extent to which his distributive share in excess thereof represents an additional return on capital. For example, if a partner who materially participates in the partnership's business could show that a passive, nonparticipating partner realized a higher return on the same amount of capital, the higher return on the service partner's capital would be excluded from NESE.

Whatever approach to bifurcation is adopted, we agree that full bifurcation is probably unnecessary for true service partnerships as long as the current exclusions from NESE continue to apply to them. That is because true service partnerships would generally invest excess capital in passive income-producing property. However, as discussed below, we believe that the definition of what constitutes a service partnership should be broadened and that guaranteed payments on partnership capital should also be excluded from NESE.

Ultimately, we believe that some type of bifurcation, along with the elimination of the special rule for service partnerships, is essential to a fair and workable legislative proposal. As noted in the introduction to this report, the 1997 Proposals were denounced by both the public and by Congress as a perceived (if not actual) expansion of

the tax base; Congress was apparently moved to adopt its moratorium on such regulations by the complaints of some that the Service was enacting a "new tax." In light of this history and the pressing need to address the problems identified in the JCT Report, we believe that the more likely avenue to achieve the JCT's goal is to fashion a proposal that does not dramatically expand the base of the SECA tax.

4. Service Partnerships.

The JCT Proposal would subject all materially-participating members of enumerated "service" entities to employment taxes on 100% of their income from the entity, without regard to the present law exceptions for items such as dividends and investment interest. We believe this portion of the JCT Proposal is ill-advised and should be eliminated.[11] As noted above, the scope of the general SECA rule is very broad to begin with. We see no reason to expand it further by eliminating the current-law exceptions for dividends, interest and similar items of passive income.

The JCT offered no rationale for this special rule. While the 1997 Proposals contained a special service partner rule, they did so as a means of treating certain service *partners* as per se materially participating, not to change the law regarding items includible in NESE. The 1997 Proposals applied only to service partners, not all partners, of service partnerships. Given the JCT Proposal's expanded definition of material participation, we see no need for a special service partnership rule.

[11] Although our Health Care Report accepted a modified per se rule for service partnerships, that rule had been proposed as legislation and would have treated only 80% of a service partner's distributive share income as NESE, in effect recognizing that any per se rule is arbitrary and that even service partnerships generate some income from capital.

Presumably, the JCT proposal was motivated by a belief that the current-law exceptions were needed as a matter of rough justice only for those businesses in which capital is a material income-producing factor. We are aware of no basis for such a belief, which seems incorrect. Even general partners of law firms earn some interest and dividend income on invested capital, and we see no reason to treat such receipts as NESE. The present-law exclusions from NESE contained in Section 1402(a) conform to the distinction, made generally throughout the Code, between compensation for services and other types of income. [12]

Moreover, we see no reason to adopt a rule that treats the owners of only enumerated types of service businesses (apparently imported from the personal service corporation rules) differently from the owners of other service businesses. If one of the principal goals of the JCT Proposal is to conform the employment taxation of similarly-situated taxpayers, we do not understand why owners of engineering or architectural firms should be treated less generously than owners of investment banking or other service firms. If the JCT or Congress believes that the current-law carve-outs from the definition of NESE are overly generous, we think the better answer is to modify Section 1402(a) in a way that applies to all owners of interests in pass-through entities.

Many service partnerships make distributions to partners each year in the nature of self-charged interest, based upon a stated percentage of each partner's capital in the firm. These distributions are treated as guaranteed payments for capital within the

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[12] For example, because the distributive share income allocated to a general partner of an investment fund would ordinarily consist of investment income and capital gains, such income is not NESE. We do not understand anything in the JCT Proposal to affect this longstanding rule.

meaning of Section 707(c) of the Code. In addition to preserving the current exclusions from NESE of passive income earned by service partnerships, we believe that the same considerations that lead to our recommendation for bifurcation support expanding the exclusions from NESE for these types of guaranteed payments, subject to the requirement that they be reasonable in amount.[13]

5. Extension to S Corporation Shareholders.

We generally agree with the spirit of the JCT Proposal that the employment taxation of S corporation shareholders should be conformed with that applicable to partners. We are also sympathetic to the enforcement problems encountered by the Service in policing this area so as to prevent S corporation shareholders from underreporting their FICA income. We therefore agree that if the SECA rules applicable to partners are to be modified, it is in the Treasury's interest to conform the S corporation rules so as not to provide artificial incentives for individuals to choose the S corporation form.

If legislation is adopted treating S corporation shareholders as subject to SECA, consideration needs to be given to how S corporation shareholders should be treated for other purposes under the Code. One approach would be to adopt a rule treating S corporation shareholders as self-employed individuals, and not as employees, for all purposes of the Code. Another approach would be to treat S corporation shareholders as self-employed only for purposes of SECA and possibly other identified

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[13] As a general rule, the reasonableness of guaranteed payments for capital would be self-policing, because partners with smaller amounts of invested capital (typically younger partners) would not agree to shift unreasonable amounts of income to partners with higher amounts of capital.

sections of the Code. We expect that under either approach, a number of correlative changes would be required, including to the pension provisions of the Code.[14]

We do believe that the prospect of transferring what will probably be thousands of taxpayers into the estimated tax system from the employee withholding tax system will significantly increase individual concerns over complexity in the tax law, and may decrease compliance. We therefore suggest that consideration be given to revisiting the tax collection rules for self-employed persons in connection with any attempt to conform the partnership and S corporation employment tax regimes.

As noted above, expansion of Section 1402(a) in its current form to S corporation shareholders would represent a very significant expansion of the SECA tax base, and extension of the special rule for service S corporations would expand the base even further. If for these or other reasons, Congress were to decide not to make any substantive changes to the taxation of S corporation shareholders, we would support enactment of the JCT Proposal without the S corporation portions thereof. We believe that the need to amend Section 1402(a) of the Code to rationalize the treatment of different types of partners is sufficiently pressing that it should not be delayed by the challenges of including S corporation shareholders under the same regime.

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[14] One example where such change might have unanticipated impacts is in the application of section 67, relating to miscellaneous itemized deductions. In the recent case of *R. O. Craft*, T.C. Memo. 2005-197, the Tax Court held that an S corporation shareholder was entitled to deduct business expenses incurred in his role as shareholder and employee of the S corporation, but only to the extent such expenses exceeded the 2% limitation of section 67. The reason given was that unreimbursed expenses of employees are subject to such limitation. If an S corporation shareholder is treated as self-employed, no such limitation would apply.