Partners' Compensatory Income: We May Be Lost but We're Making Really Good Time

NOTE: THIS IS A PRELIMINARY AND INCOMPLETE DRAFT OF WHAT WILL BECOME AN ARTICLE DEALING WITH AN ISSUE THAT MAY WELL BE CONSIDERED IN TAX REFORM LEGISLATION WHICH IS SAID TO BE RELEASED WITHIN DAYS. THIS DRAFT IS INTENDED TO PROVIDE BACKGROUND ON THE ISSUE DISCUSSED BELOW AND TO FOCUS ON SOME OF THE QUESTIONS THAT SHOULD BE ADDRESSED IN THIS AREA. ITS CONCLUSIONS DO NOT REFLECT THE THOUGHTS OF THE AUTHOR AS NEITHER THIS DRAFT NOR THE AUTHOR HAVE REACHED A CONCLUSION ON THE ISSUES THAT MAY BE RAISED IN TAX REFORM LEGISLATION WHEN AND IF IT IS RELEASED. IF POSSIBLE IT MAY BE SUPPLEMENTED BEFORE OR AT THE TIME OF THE PRESENTATION DEPENDING ON WHAT IS RELEASED BY THAT DATE

I. Introduction and Background

A. The Issue under Consideration

Income [and deductions] derived [by individuals] from the performance of services has long been distinguished from other sorts of income [and deductions] for purposes of Federal taxation. The policy reasons for the distinction have varied and have not always been clear, and the manner in which the distinction has been drawn has been idiosyncratic.

In some respects, this effort is circular. In order to determine an appropriate manner of distinguishing compensatory income from non-compensatory income, it is necessary to understand the sort of income that has been treated as "compensatory" under existing or proposed tax provisions. Traditionally, the tax treatment of compensatory income and associated deductions has occurred in the context of service providers and the difficult definitional issues surrounding service providers who are also equity owners in the organization.

This program will focus on the taxation of partners who provide services to their partnership. What is often thought of as a simple tax question of how service partners are treated, actually comprises several discrete and underdeveloped areas of tax law. Starting with the decades old question of whether a partner can be an employee of the partnership (sometimes referred to as the "dual status" question), continuing with the treatment a service provider's receipt of an interest in a partnership as consideration for services to the partnership, on to the question of how distributions or guaranteed payments to a partner are treated for self-employment taxes and whether a partner may exclude a share of income from net income from self-employment to the extent the partner holds a "limited partner interest," and, depending on developments to the date of the program, possible discussions of compensatory options in partnerships, carried interests, and the treatment of a distributive share as "qualified business income" to the extent it exceeds "reasonable compensation."

B. Current Taxation of Compensatory Income

1. Wages and Self-Employment Income

An individual service provider may be treated as an employee[1] or a self-employed individual.[2] The compensation paid to an employee ("Wages") are taxable to the employee as ordinary income[3] and are subject to employment taxes consisting of an Old-Age, Survivors, and Disability Insurance ("OASDI") tax and a Hospital Insurance ("HI") tax (imposed jointly on the employer and the employee under the Federal Insurance Contributions Act ("FICA"). A "self-employed individual" an individual who has "earned income." "Earned income" is net earnings from self-employment ("NESE") arising from a trade or business in which the individual's services are a material income-producing factor.[4] Net earnings from self-employment (NESE) is the gross income less deductions of an individual from any trade or business carried on by such individual and an individual tax partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by a tax partnership of which the individual is a tax partner.[5] NESE is computed by excluding certain types of income including gains and losses,[6] certain income from real property rentals,[7] certain interest and dividends,[8] the distributive share of a tax partner who is a limited partner of income and loss of a tax

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[1] Under IRC § 3121(d) an "employee is any officer of a corporation, any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee; or any individual who performs services for remuneration for any person who performs certain types of services if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; unless such individual has a substantial investment in facilities used in connection with the performance of such services or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed; or any individual who performs services that are included under an agreement entered into pursuant to section 218 of the Social Security Act." Of course, "employee" has different meanings for different uses. For example, under Reg. §1.132-1(b)(1) for purposes of fringe benefits, an employee is an individual currently employed by the employer in the line of business; an individual formerly employed by the employer in the line of business who separated from service by reason of retirement or disability; the widow or widower of an individual who died while employed by the employer in the line of business or who separated from service by reason of retirement or disability; and the spouse or dependent child of the employee. Thus, for example, the use of qualified discounts on services or merchandise by the spouse or dependent children of a store employee are excludable to the same extent as if used by the employee. A partner who performs services for a partnership is considered an employee of the partnership for this purpose. In contrast, under Reg. §1.132-1(b)(2) and Priv. Ltr. Rul. 199929043, for purposes of other fringe benefits rules employee includes a widow or widower or a dependent child. Reg. §1.132-1(b)(1). The definition of "employee" is narrower for working condition fringes because of the requirement that the hypothetical payment be in connection with the employee's performance of services for the employer. Similarly, in *Hathaway v. Comm'r.*, T.C. Memo. 1996-389, T.C.M. (RIA) P 96389 (1996), the court held that a taxpayer described as an employee in IRC §3121(d)(3) is not necessarily an employee for purposes of the treatment of the taxpayer's business expense deductions.

[2] IRC § 401(c)(3) (sometimes referred to as an "owner-employee").

[3] IRC § 61(1).

[4] IRC § 401(c).

[5] IRC § 1402(a).

[6] IRC § 1402(a)(3).

[7] IRC § 1402(a)(1).

[8] IRC § 1402(a)(2).

partnership,[9] and certain other types of income. Earned income is taxable to the self-employed individual as ordinary income, and is subject to self-employment taxes consisting of OASDI and HI taxes (imposed exclusively on the self-employed individual under the Self-Employment Contributions Act ("SECA"). A self-employed individual who is the owner of a disregarded entity or a tax partner holding 10% of the capital or profits of a tax partnership is also an "owner-employee."

Thus, an individual conducting a trade or business as a sole proprietor or through a disregarded entity or an individual tax partner may be treated as a self-employed individual. There are several differences between the treatment of payments to employees and distributions to non-employees. Payments in exchange for services by employees will be characterized as wages. This section and subsequent sections address the treatment of the characterization of an individual as an employee for tax purposes, which will not necessarily be the same as his or her treatment under non-tax law.[10]

The rates of FICA and SECA taxes are the same (although in the case of FICA taxes divided between the employer and employee while, in the case of SECA, borne entirely by the self-employed individual), the income upon which they are assessed are not identical. FICA taxes are imposed on compensatory income, assuming that all wages are paid for services rendered. NESE, on the other hand, with a few exceptions, is imposed on net business income of self-employed person, which may include income from both capital and services. Additionally, FICA income is generally[11] imposed directly on compensatory income paid to the employee (presumably in an amount approximating "reasonable compensation"), while SECA taxes are imposed on the net taxable income of the business allocated to the self-employed individual. The differences are discussed at length in a 2012 Congressional Budget Office study (the 2012

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[9] IRC § 1402(a).

[10] For example, in *Clackamas Gastroenterology Associates, P. C. v. Wells*, 538 U.S. 440, 123 S. Ct. 1673, 155, 155 L. Ed. 2d 615 (2003), the Supreme Court set forth the following tests to determine whether a director/officer of a medical professional corporation would be an employee for the determination of whether the corporation had 15 or more employees for purposes of the Americans with Disabilities Act based on the EEOC Compliance Manual § 606:00011:

> (1) Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work.
>
> (2) Whether and, if so, to what extent the organization supervises the individual's work.
>
> (3) Whether the individual reports to someone higher in the organization.
>
> (4) Whether and, if so, to what extent the individual is able to influence the organization.
>
> (5) Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts.
>
> (6) Whether the individual shares in the profits, losses, and liabilities of the organization.

See also, *Simpson v. Ernst & Young*, 100 F.3d 436, 443 (6th Cir. 1996), *cert. denied*, 520 U.S. 1248 (1997) and *EEOC v. Sidley Austin Brown & Wood*, 315 F.3d 696, 707 (7th Cir. 2002) (considering partners in professional firms as employees for purposes of the Age Discrimination in Employment Act (ADEA) and Employee Retirement Income Security Act (ERISA)).

[11] Not including certain forms of compensation, most notably health insurance, which is not included in income.

CBO Study") that found a significant disparity in the treatment of the same economic results between the FICA and SECA approaches resulting from difference between the way in which wages and NESE are computed.[12] While the 2012 CBO study is concerned exclusively with employment taxes, the differences would largely apply to income of the respective individuals under the federal income tax regime because the FICA compensatory income, wages, is all ordinary income derived from services, while NESE excludes some capital-based income and non-taxed return of capital or exempt income resulting in a lower amount of income and includes other capital-based income which would be excluded under the FICA regime. The 2012 CBO Study goes on to suggest three alternative ways in which the SECA tax base might be changed in order to bring SECA into closer alignment with FICA:[13]

> - A *material participation standard* would change the criteria for determining which partners must pay SECA taxes on their share of business income and extend those criteria to LLC members. Such a standard would clarify much of the ambiguity surrounding the SECA tax but, on balance, would subject more income from capital to the self-employment tax.
> - A *reasonable compensation standard* for identifying labor income and including it in the SECA tax base would exclude capital income from the SECA tax base by definition and require all labor income to be included. If the option was limited to partnerships (including multimember LLCs), it would, on average, increase the included share of labor income. If sole proprietorships were included, however, the opportunity to mischaracterize labor income as capital income (a choice not available under current law) would probably reduce the included share of labor income.

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[12] Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax (September 27, 2012) available at https://www.cbo.gov/publication/43644. The study at page 1 highlights the magnitude of this difference:

> CBO estimates that approximately 40 percent of the SECA-HI tax base (the amount of self-employment income subject to the HI tax) derives from capital, and the remainder derives from labor. Furthermore, more than half of the labor income of self-employed people—that is, the portion of their business income that would be subject to the FICA-HI tax if the business was incorporated instead of being a sole proprietorship or a partnership—is no included in the SECA-HI tax base. That occurs because when net income from all of a taxpayer's businesses is less than the labor income from those businesses, the excess labor income is excluded from the SECA tax base. There is no similar exclusion from the FICA tax base. With both the taxed capital income and the excluded labor income accounted for, the total SECA-HI tax base is roughly three-quarters of the amount of income that would be taxable under the FICA-HI rules.

[13] 2012 CBO Study page iii.

- A *safe harbor for a return on capital* would provide taxpayers with a formula that used their tangible assets to calculate how much capital income should be excluded from the SECA tax base. The policy that CBO examined would shelter a relatively small share of capital income, probably reflecting the importance of intangible capital (such as patents, trademarks, and intellectual property) in generating income for unincorporated businesses. Furthermore, such a policy would reduce the included share of labor income in cases where the return on capital was less than the safe-harbor amount.

2. Comparison of the Tax Treatment of Service-Providing Owners

The rules applicable to the compensation of owners for services differ among individuals conducting business as disregarded entities or sole proprietors, tax partnerships, C corporations, or S corporations. As noted below, ordinarily a sole proprietor or a tax partner, if receiving compensatory distributions, is characterized as a self-employed individual, while an employee of a tax corporation with some exceptions, is treated as an employee. There are times that a 2% shareholder (any person who owns or constructively owns more than two percent of the outstanding stock of such corporation or stock possessing more than two percent of the total combined voting power of all stock of such corporation)[14] will be limited in the same way as a partner. Some of the consequences of the characterization are set forth below:[15]

Item **For 2017**	**Employee**	**Employee and 100% Owned C Corporation**	**2% S Corporation Shareholder**	**Sole Proprietor**	**Tax Partner**
Characterization	Employee[16]	Employee[17]	Owner-Employee[18]	Owner-Employee or Self-Employed Individual[19]	

[14] IRC § 1372(a)(2).

[15] Taxes are limited to Federal income and employment taxes. There may be additional state taxes. Also no credits are included.

[16] IRC §3121(d).

[17] IRC §§3121(d) (definition of employee) and 1372 (for purposes of fringe benefits, 2% shareholder subject to partnership rules).

[18] IRC §§3121(d) (definition of employee) and 1372 (for purposes of fringe benefits, 2% shareholder subject to partnership rules);IRC §401(c)(3)(B).

[19] IRC §401(c)(3)(A).

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Employ-ment/Self-employment tax imposed upon each employee	7.65% of wages up to $127,200[20] 1.45% of wages from $127,200 to $250,000 2.35% of wages above $250,000[21]	21.3% of wages up to $7,000[22] 15.3% of wages up from $7,000 to $127,200 2.9% of wages from $127,200 to $250,000 3.8% of wages above $250,000[23]	7.65% of wages up to $127,200[24] 1.45 % of wages from $127,200 to $250,000 2.35% of wages above $250,000[25]	15.3% of NESE up to $127,200 2.9 % of NESE from $127,200 to $250,000 3.8% of NESE above $250,000	
Employment tax and unemploy-ment insurance tax payable by employer with respect to each employee	13.65% of wages up to $7,000[26] 7.65% of wages up from $7,000 to $127,200 1.45% of wages above $127,200	15.65% of wages up to $7,000[27] 7.65 % of wages up from $7,000 to $127,200 1.45% of wages above $127,200	15.65% of wages up to $7,000[28] 7.65% of wages up from $7,000 to $127,200 1.45% of wages above $250,000	None	

[20] IRC §§ 3101(a) and 3101(b)(1)

[21] IRC §§ 3101(b)(1).

[22] IRC §§ 3301(2), 3306(b). (FUTA imposed on wages up to $7,000. Note that this tax is coordinated with state unemployment taxes, which, in turn are subject to an experience rating).

[23] IRC §§ 3101(b)(1).

[24] IRC §§ 3101(a) and 3101(b)(1)

[25] IRC §§ 3101(b)(1).

[26] IRC §§ 3301(2), 3306(b). (FUTA of 6% of wages imposed on wages up to $7,000. Note that this tax is coordinated with state unemployment taxes, which, in turn are subject to an experience rating).

[27] IRC §§ 3301(2), 3306(b). (FUTA imposed on wages up to $7,000. Note that this tax is coordinated with state unemployment taxes, which, in turn are subject to an experience rating).

[28] IRC §§ 3301(2), 3306(b). (FUTA imposed on wages up to $7,000. Note that this tax is coordinated with state unemployment taxes, which, in turn are subject to an experience rating).

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Employment and withholding obligations of employer	The employer is obligated to withhold employee's share of employment taxes (FICA and HI taxes) from the wage payments to the employee.[29] To the extent the employee has wages from any employer in excess of $200,000, the employer is obligated to deduct and pay over the employee's liability for the 0.9% additional tax.[30]			A sole proprietor may not be his or her own employee[31] and is thus not subject to withholding or employment tax but must pay estimated taxes.[32]	Tax partners are not subject to withholding, but are required to pay estimated taxes.[33] Except in the case of foreign partners[34] the tax partnership is not obligated to withhold with respect to tax partners.[35]
Is amount subject to Employment taxes determined by reference to "reasonable compensation"?	Yes			No	

[29] IRC §3101 (OASD tax of: (i) 6.2% of wages as defined in IRC §3121(a) (all remuneration up to the contribution and benefit base determined under section 230 of the Social Security Act), (iii) HI tax of 1.45% of wages (unlimited by the contribution and benefit base) and additional tax of 0.9% (above 3402 threshold).

[30] IRC § 3102(e) and (f).

[31] A sole proprietor may not be an employee of a sole proprietorship. Nottingham, Bertha V. Est, (1956) TC Memo 1956-281 ("A sole proprietor cannot deduct amounts paid to himself as compensation unless he restores that amount to income by reporting the compensation."). Publication 334 ("You cannot deduct your own salary or any personal withdrawals you make from your business. As a sole proprietor, you are not an employee of the business.")

[32] IRC § 6654.

[33] IRC § 6654. *See also* Reg. §1.707-1(c) ("For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, 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.").

[34] IRC § 1446.

[35] Rev. Rul. 69-184, 1969-1 C.B. 256. Note that there is a mechanism for correcting misclassification mistakes. Under IRC §6413 it is possible to obtain a refund of erroneously-paid employment taxes. Nonetheless, matters of statutes of limitations and interest may preclude a complete restitution for erroneous characterization of a partner as an employee.

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Income and withholding on issuance of interest in the organization to a service provider	To the extent the value of the interest is included in the income of the employee, it will constitute wages and be subject to withholding. There are alternative treatments of the withholding amount. The value of the interest may be combined (1) with wages paid or to be paid within the same calendar year for the last preceding pay period, or (2) with wages for the current pay period.[36]			Generally there is no recognition of income on the "creation" of a sole proprietorship.	If the interest of a person already a tax partner is increased, the results are unclear. If the change is merely a change in the tax partner's share of profits, there is probably not a taxable event. On a "capital shift" the partner receiving an increase in capital may have income. In any case there is no withholding.
Carried or Profits Interests	An employee is generally not taxed on entering into an employment contract but all payments on an employment contract are ordinary wage income.[37]			There is no concept of a "profits interest" in a sole proprietorship.	A partner receiving a "profits interest" in a partnership in exchange for services performed for the partnership will not recognize gain on the receipt of the interest.[38] In addition, the disposition of a profits interest may give rise to capital gain rather than ordinary income.[39]

[36] Reg. § 31.3402(g)-1(a)(2).

[37] Rev. Proc. 2004-110, 2004-2 CB 960.

[38] Rev. Procs. 93-27, 1993-2 CB 343 and 2001-43, 2001-2 CB 191.

[39] IRC § 741, *but see*, Donald Trump's tax plan on its website at https://www.donaldjtrump.com/policies/tax-plan/ ("Carried interest will be taxed as ordinary income.). See also, the Carried Interest Fairness Act of 2017, H.B. 2295 115th Cong. First Sess. (providing that a partnership interest given for services will be treated as if its fair market value were its liquidation value, and the person receiving the interest shall be treated as if they made an IRC § 83(b)

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Reporting form	W-2 (employee)			1099 (independent contractor)	K-1 (tax partner).
Deduction of unreimbursed expenses of conducting business	Expenses paid by an employee are unreimbursed business expenses which are subject to substantiation requirements,[40] and must be taken as an itemized deduction subject to the 2% adjusted gross income floor[41] and the phase-out of itemized deductions.[42]			Ordinary and reasonable expenses incurred in the operation of a sole proprietorship (i.e., trade or business) may be deducted against its income.[43]	A tax partner who is not reimbursed by the tax partnership may be able to deduct expenses as necessary and proper for the conduct of business.

election and, in the case of "investment services partnership interests" treating net capital gain as ordinary income, treating qualified dividends as not being qualified, disallowing the application of IRC § 1202 to qualified small business stock, treating gain on the disposition of a partnership interest as ordinary income, requiring the recognition of gain (as ordinary income) on the receipt of a distribution of property.)

[40] Reg. § 1.162-17.

[41] IRC § 67; Reg. §1.67-1T(a)(i).

[42] IRC § 68.

[43] IRC § 162.

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Employment Taxes[44] and Self-Employment Taxes	Wages are subject to employment taxes, while dividends are not.[45]		S corporations and their shareholders can, within certain limitations, allocate income between amounts subject to employment taxes and amounts that are distributive shares of non-employment income.	The income of an independent contractor (individual sole proprietor) will NESE.[46]	The distributive share of ordinary income and loss of a tax partner from a trade or business conducted by the partnership (other than dividends, interest, and real estate rentals) constitute NESE, and are subject to self-employment taxes.[47] NESE does not include a limited partner's share of income or loss, except with respect to guaranteed payments for services.[48]

[44] For 2017, self-employment taxes will be imposed on net earnings from self-employment at the rate of 15.3% on the first $ 127,200 and 2.9% on amounts of net earnings from self-employment in excess of $ 127,200. IRC §§3101(a), 3111(a), and 3.8% above "Threshold Amount" threshold described above. Under IRC §164(f), the self-employed person is entitled to an above the line deduction for one-half of the self-employment taxes. The Patient Protection and Affordable Care Act §§9015(b)(1) and 10906(b) (P.L. 111-148) increased the 2.9% self-employment tax to 3.8% for taxpayers with self-employment income in excess of $250,000 (on a joint return), $125,000 (for married taxpayers filing separately) or $200,000 for other taxpayers. In addition, each of the employer and employee must pay a Medicare hospital tax on the total (uncapped) amount of wages equal to 1.45%. IRC §3101(b); IRC § 3111(b). Starting in 2012, the Patient Protection and Affordable Care Act §§9015(a)(1) and 10906(D) (P.L. 111-148) increased the 1.45% hospital insurance tax imposed on the employee to 2.35% for taxpayers with wages in excess of $250,000 (on a joint return), $125,000 (for married taxpayers filing separately) or $200,000 for other taxpayers. If the 0.9% increase is not withheld from the employee, it will be treated as Self-Employment Contributions Act (SECA) tax. Health Care and Education Reconciliation Act of 2010 §1402(b)(2) (P.L. 111-152). A self-employed individual is not entitled to deduct one-half of the additional 0.9% self-employment tax under IRC §164(f).

[45] *Robinson v. Comm'r.*, 117 T.C. 308, 2001 WL 1631867 (2001) ("The fact that an individual did not receive remuneration in the form of wages or that the individual reported self-employment income (or other remuneration besides wages) on a Schedule C does not prevent the individual from being classified as an employee. *Pariani v. Comm'r*, T.C. Memo. 1997-427; *Jacobs v. Comm'r*, T.C. Memo. 1993-570.").

[46] IRC § 1402(a).

[47] IRC § 1402(a).

[48] IRC § 1402(a)(13).

<table>
<tr><th>Item
For 2017</th><th>Employee</th><th>Employee and 100% Owned C Corporation</th><th>2% S Corporation Shareholder</th><th>Sole Proprietor</th><th>Tax Partner</th></tr>
<tr><td>“Reasonable compensation” for owners</td><td colspan="3">In the case of employees who are also shareholders, the amounts treated as “wages” must constitute “reasonable compensation” for both income and employment tax purposes.[49]</td><td>The amount includible in a sole proprietor’s NESE is determined without respect to the reasonableness of the amount.[50]</td><td>The amount includible in an partner’s NESE is determined without respect to the reasonableness of the amount.[51]</td></tr>
<tr><td>Additional OASDI/FICA/Net Investment Income (“NII”) Tax</td><td colspan="2">An employee with wages over the “threshold amount” will be subject to an additional .9% tax.[52] To the extent that an individual shareholder receives dividends, the dividends may be subject to NII tax unless the shareholder actively participates in the business of the corporation.</td><td>An employee with wages over the “threshold amount” will be subject to an additional .9% tax.[53] To the extent that an individual shareholder receives allocable shares of income, that income may be subject to NII tax unless the shareholder actively participates in the business of the corporation.</td><td>A sole proprietor having income in excess of the “threshold amount” will be subject to the additional .9% self-employment tax. [54]</td><td>An individual tax partner whose distributive share exceeds the “threshold amount” will be subject to the additional .9% self-employment tax.[55] An individual tax partner who is not treated as having NESE[56] will be subject to the NII tax unless the partner actively participates in the business of the partnership.[57]</td></tr>
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[49] Compensation is not deductible to the extent it is in excess of reasonable compensation. Treas. Reg. §§ 1.162-7(b)(3) and 1.162-9. In the case of an S corporation, shareholder/employees must have wages in an amount equal to reasonable compensation. *Dunn & Clark P.A.*, 57 F3d 1076 (9th Cir. 1995); *Spicer Accounting Inc.*, 918 F2d 90 (9th Cir. 1990); *Joseph Radtke, S.C.*, 895 F2d 1196 (7th Cir. 1990).

[50] IRC § 1402(a); Rev Rul 54-613, 1954-2 CB 269.

[51] IRC § 1402(a); Rev Rul 54-613, 1954-2 CB 269.

[52] IRC § 3101(b)(2). The additional .9% is borne by the employee and no part of it is deductible.

[53] IRC § 3101(b)(2). The additional .9% is borne by the employee and no part of it is deductible.

[54] IRC § 1401(b)(2). The additional .9% is borne by the tax partner and no part of it is deductible. One-half of remaining OASDI portion of the NESE (2.9%) is deductible under IRC § 164(f).

[55] IRC § 1401(b)(2). The additional .9% is borne by the tax partner and no part of it is deductible. One-half of remaining OASDI portion of the NESE (2.9%) is deductible under IRC § 164(f).

[56] A limited partner under IRC § 1402(a)(13).

[57] IRC § 1411 (a 3.8% tax on income above a threshold amount). Note, it may be possible for some partners (for example a limited partner who is actively participating in the business of the partnership) to avoid both self-

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Timing of income	All amounts paid to the employee are included in income at the time of payment.			A sole proprietor will report his or her income based on the sole proprietor's method of accounting.	Except with respect to guaranteed payments, a partner includes his or her share of partnership income reflected on form K-1 as and when such income is recognized by the tax partnership regardless of when or if the income is distributed to the partner. In the case of guaranteed payments, the payment is included in ordinary income in the year in which the payment is paid or accrued under the tax partnership's method of accounting.[58]
Treatment of payments for purposes of determining "qualified production activities income"[59]	"W-2 Wages," regardless of whether the employees are also shareholders, will qualify.[60]			A sole proprietor's self-employment income will not count as "W-2 Wages."[61]	A tax partner's distributive share of income or distributions will not count in determining "W-2 Wages." [62]

employment and net investment income taxes. *But see*, Donald Trump's tax plan at https://www.donaldjtrump.com/policies/tax-plan/ ("The 3.8 percent Obamacare tax on investment income will be repealed, as will the alternative minimum tax.").

58 Reg. § 1.707-1(c).

59 Under IRC § 199 (added by Sec 102 of the American Jobs Creation Act of 2004 (HR 4520), P.L. 108-357), there is a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the taxpayer's "qualified production activities income." For taxable years beginning after 2009, the deduction is equal to 9% of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this provision) for the taxable year.

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Character of Income	Wages received by an employee will be ordinary income.[63] Dividends received by a shareholder of a C corporation will be subject to the same preferential rate as applicable to net capital gains (0%, 15%, or 20%).[64] Income of the S corporation received by a shareholder of an corporation is taxed at ordinary income rates.[65]		Wages received by an employee will be ordinary income.[66] Income of the S corporation received by a shareholder of an corporation is taxed at ordinary income rates.[67]	The character of income of a sole proprietor will be determined by type of transaction generating the income.	Except with respect to guaranteed payments, which will be ordinary income, the character of a partner's distributive share of partnership is determined at the partnership level.[68]

[60] IRC §199(b) (which limits the benefits of the deduction in connection with domestic production activities to an amount equal to 1/2 of the "W-2 wages" paid in the activity).

[61] Because self-employment income is not required to be reported under IRC §6051, it will not qualify as "W-2 Wages."

[62] Because self-employment income is not required to be reported under IRC §6051, it will not qualify as "W-2 Wages."

[63] IRC §106.

[64] IRC §1(h)(11).

[65] IRC §1366 (income (and character) passed through to shareholders).

[66] IRC §61(a).

[67] IRC §1366 (income (and character) passed through to shareholders).

[68] In some cases distributions of cash in redemption of a tax partner's interest in unrealized receivables and inventory will constitute ordinary income. IRC § 751.

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Personal Use of Entity Property and other than as a Qualified Fringe Benefit	Except as provided in IRC §132, personal use of the employer's property by an employee may be taxable as compensation income or a constructive dividend if the employee is a shareholder.			A sole proprietor will have no income as a result of using the its own property.	The tax consequences of a tax partner's personal use of the partnership's property is unclear.
Payment of Accident and Health Insurance Plans	Deductible to the employer[69] and excludible by the employee.[70]		Deductible to the employer[71] and includible by the employee.[72]	A sole proprietor may deduct the cost of accident and health insurance policies,[73] but the self-employed person may deduct the cost of insurance,[74] and may exclude benefits under such plans from income. [75]	If paid without regard to partnership income, deductible to the partnership (and as such, deductible by the partners)[76] but the partner must include the cost of the premiums in income.[77]
Exclusion of Health Insurance Premiums from Compensatory Taxes	Health insurance costs are excluded from an employee's wages in determining OASDI and HI taxes.[78]		Health insurance costs are not excluded from an employee's wages in determining OASDI and HI taxes.[79]	Self-employed individuals (such as partners and sole proprietors) are not allowed to deduct their health insurance costs from NESE in determining tax under section IRC §§ 1401(a) and 1401(b) for old-age, survivors and disability insurance and hospital insurance.[80]	

[69] IRC §162(1). Rev. Rul. 91-26, 1991-1 CB 184.

[70] IRC §106.

[71] IRC §162(1). Rev. Rul. 91-26, 1991-1 CB 184.

[72] IRC §§ 162(l)(5), 1372(a).

[73] IRC §§105(g), 162(l), and 401(c).

[74] IRC §§ 162(l) and 401(c).

[75] IRC §§104(a)(3) and 401(c).

[76] IRC §§162(1), 707(c), and 401(c). Rev. Rul. 91-26, 1991-1 CB 184.

[77] Rev. Rul. 91-26, 1991-1 CB 184.

[78] IRC § 3121(a)(2).

[79] IRC §§ 162(l)(5), 1372(a).

[80] IRC § 162(l)(4).

Item For 2017	Employee	Employee and 100% Owned C Corporation	2% S Corporation Shareholder	Sole Proprietor	Tax Partner
Group Term Life Insurance	Premiums paid for group term life insurance up to $50,000 of such insurance on employees are deductible to the employer[81] and excludible by the employee.[82]		No exclusion for a 2% shareholder.[83]	No deduction or exclusion.	Premiums paid for group term life insurance by a partnership may be deductible by the partners as a guaranteed payment if they are paid for services by the partner, but the partner may not deduct the payment.
Contributions to Health Savings Accounts	Contributions to a health savings account are deductible to the employer,[84] and excludible by the employee,[85] and not included in income when used to pay qualifying expense.		No deduction for HSAs for 2% shareholders. [86]	Contributions to a health savings account are deductible to the partnership assuming they are paid for services performed by the partner,[87] and included in income as NESE but are deductible by the partner above the line.[88]	

[81] IRC § 162.

[82] IRC § 79.

[83] IRC §§ 162(l)(5), 1372(a).

[84] IRC § 162.

[85] IRC § 106.

[86] IRC § 223. Notice 2005-8, 2005-1 CB 368 Answer A-2. While the result of this is that the amount of the contribution is treated as NESE for purposes of employment taxes, in the case of a 2% shareholder in an S corporation, the contribution will not be subject to FICA taxes. Notice 2005-8, 2005-1 CB 368.

[87] IRC §§ 707(c), 162.

[88] IRC §§ 1372(a)and 223. Notice 2005-8, 2005-1 CB 368 Answer A-2.

<table>
<tr><th>Item
For 2017</th><th>Employee</th><th>Employee and 100% Owned C Corporation</th><th>2% S Corporation Shareholder</th><th>Sole Proprietor</th><th>Tax Partner</th></tr>
<tr><td>Meals or lodging furnished for the convenience of the employer</td><td colspan="3">Meals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment are excluded from the employee's income.[89]</td><td>There is no income tax effect of an individual sole proprietor's supplying him or herself with food or lodging and no deduction unless another business deduction is available.[90]</td><td>Meals and lodging furnished to a tax partner who provides services to the partnership employee, his spouse, and his dependents, pursuant to employment may be deductible.[91]</td></tr>
<tr><td>Qualified transportation fringes</td><td colspan="2">Employees are entitled to exclude qualified transportation fringe benefits (receive certain fringe benefits such as transportation in a commuter highway vehicle, transit pass, qualified parking, and qualified bicycle commuting reimbursement employer parking tax-free.[92]</td><td colspan="3">2% S corporation shareholders,[93] self-employed individuals, and tax partners may not exclude transportation fringe benefits.[94] Payments made on behalf of self-employed individuals and tax partners are treated as income or guaranteed payments to the recipient partners.[95]</td></tr>
<tr><td>No additional cost, qualified employee discount, working condition fringe, and de minis fringe benefits</td><td colspan="3">An employee may exclude cost, qualified employee discount, working condition fringe, and de minis fringe benefits from income.[96]</td><td>Not applicable</td><td>A tax partner who performs services for a partnership is considered an employee of the partnership.[97]</td></tr>
</table>

[89] IRC § 119.

[90] See, e.g., IRC § 162(a)(2) (travel expenses).

[91] IRC § 704(e).

[92] IRC § 132.

[93] IRC § 1372(a).

[94] IRC § 132(f)(5)(E) ("employee" does not include persons who are self-employed), Treas. Reg. §1.132-9(a)(1) A-24.

[95] Rev. Rul. 91-26, 1991-1 C.B. 184.

[96] IRC § 132(a), (b)(1).

[97] Treas. Reg. § 1.132-1(b)(1) .

<table>
<tr><th>Item
For 2017</th><th>Employee</th><th>Employee and 100% Owned C Corporation</th><th>2% S Corporation Shareholder</th><th>Sole Proprietor</th><th>Tax Partner</th></tr>
<tr><td>Cafeteria plans</td><td colspan="2">Except with respect to key employees, no amount is included in gross income of an employee who participates in a cafeteria plan.[98]</td><td colspan="3">2% S corporation shareholders,[99] self-employed individuals, and tax partners are not entitled to participate in a cafeteria plan.[100]</td></tr>
<tr><td>Workers compensation</td><td colspan="3">Premiums paid by an employer are deductible if paid on behalf of an employee.[101]</td><td colspan="2">Premiums for workers compensation are deductible only with respect to employees other than self-employed individuals.[102]</td></tr>
<tr><td>Affordable Care Act (ACA) required coverage</td><td colspan="3">An applicable large employer[103] must offer affordable care to all employees who work an average of 30 or more hours per week or pay a penalty.[104]</td><td colspan="2">Self-employed individuals are probably not considered employees for purposes of the ACA.[105]</td></tr>
<tr><td>Income, gift and estate tax consequences</td><td colspan="4">An employee's (or independent contractor's) gratuitous transfer of such interest to a family limited partnership (or other family-owned entity) would appear to constitute a completed transfer for gift and estate tax purposes, but may not constitute a transfer for income tax purposes under assignment of income principles.</td><td>The transfer of such entire interest to a family limited partnership (or other family-owned entity) would appear to constitute a completed transfer not only for gift and estate, but also for income tax purposes.[106]</td></tr>
</table>

[98] IRC § 125(a).

[99] IRC § 1372(a).

[100] Prop. Reg. § 1.125-1(g)(2).

[101] IRC §162(1).

[102] IRC §162(1), Rev. Rul. 72-596, 1972-2 C.B. 395.

[103] IRC § 4980H(c)(2) defines an applicable large employer is one having employed at least 50 full-time employees.

[104] IRC § 4980H.

[105] Treas. Reg. § 54.4980H-1(a)(15) (defining an “employee” as “an individual who is an employee under the common-law standard. See §31.3401(c)-1(b). For purposes of this paragraph (a)(15), a leased employee (as defined in section 414(n)(2)), a sole proprietor, a partner in a partnership, a 2-percent S corporation shareholder, or a worker described in section 3508 is not an employee.”). *See, also* the discussion of this issue by Bret Busacker, in Shop Talk, Partners Who Are Employees in the Same Partnership: The Downsides of Dual Status, Journal of Taxation, Dec 2014 at page 283.

[106] The rights of the tax partner may be subject to IRC § 704(e). Revenue Ruling 77-137, 1977-1 C.B. 178 (limited partner's assignment of rights to share in profits, losses and distributions attributable to assigned interest constituted

C. The Mysterious Travails of IRC § 1402(a)(13)

A limited partner is not treated as having NESE except to the extent of guaranteed payments for services.[107] According to the committee reports accompanying IRC §1402(a)(13), this provision was added to prevent passive investors who do not perform services from obtaining social security coverage.[108]

Under regulations proposed in 1997,[109] a general partner would be required to include his or her distributive share of ordinary income in NESE because a general partner (other than in an LLP) has vicarious liability for partnership debts and (regardless whether the partnership is an LLP) has authority under the partnership law to bind the partnership. A general partner in a limited partnership might be able to exclude some portion of his or her distributive share of income under the two classes of interest test. To the extent that a member is treated as a limited partner for purposes of that section, the member's distributive share of income from an LLC will not be NESE. Proposals (the JCT Proposals)[110] from the Joint Committee on Taxation would have eliminated the distinction between general and limited partners. To the extent that the JCT Proposals are adopted, the distinction between general partners and limited partners will be eliminated and a limited partner would be subject to the same NESE rules as apply to a general partner described above.

The 1997 Regulations provide rules for distinguishing between "general partners" and "limited partners" for all forms of unincorporated business organizations, including general and limited partnerships. Rather than adding new subsections to the regulations, the 1997 Regulations modify existing subsections to define "limited partner" in all tax partnerships.

Under the 1997 Regulations, a member will be treated as a limited partner unless one of four exceptions applies:[111]

- <u>The Liability Test</u>: The member has personal liability for the debts of or claims against the LLC by reason of being a member.[112]
- <u>The Authority Test</u>: The member has authority (under the law of the jurisdiction in which the LLC is formed) to contract on behalf of the LLC.[113]

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the assignee as a partner for tax purposes). In Rev. Rul. 77-137, the assignor agreed to exercise any residual powers remaining in assignor solely in favor of and in the interest the assignee.

[107] IRC § 1402(a)(3).

[108] House Committee Report on Pub. L. No. 95-216, 91 Stat 1509 (1977).

[109] Notice of Proposed Rulemaking (Reg-209729-94) (RIN 1545-AS94) (January 10, 1997)).

[110] Joint Committee on Taxation, Report JCS-02-05, January 27, 2005 "Options To Improve Tax Compliance and Reform Tax Expenditures (the 2005 JCT Report); August 3, 2006 report on Additional Options to Improve Tax Compliance that was prepared by the staff of the JCT (the 2006 JCT Report).

[111] Prop. Reg. § 1.1402(a)-2(h)(2).

[112] Prop. Reg. §1.1402(a)-2(h)(2)(i).

[113] Prop. Reg. §1.1402(a)-2(h)(2)(ii).

• The Participation Test: The member participates in the trade or business of the LLC for more than 500 hours during its taxable year.[114]

• The Personal Services Test: The member provides more than a *de minimis* amount of services to or on behalf of the trade or business of an LLC, substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[115]

The 1997 Regulations provide that although an individual is not treated as a limited partner under the rules set forth above, the individual's distributive share of income attributable to certain partnership interests may be treated as the distributive share of a limited partner. In other words, the same individual who would otherwise be treated as a general partner may hold an interest as a limited partner. The 1997 Regulations accomplish this result by comparing a partnership interest of an individual treated as a general partner with interest held by individuals who would be treated as limited partners under the tests set forth above. These rules are designed to provide for the same results as would obtain in the case of a general partner who also holds a limited partnership interest. They accomplish this goal by testing both the member and the interest owned by the member.

There are two alternative tests under which the interest of a member who might otherwise be treated as a general partner will be treated as limited partnership interest:

• The Two Classes of Interest Test: An individual who is not treated as a limited partner under the liability test, the authority test or the participation test may be treated as a limited partner with respect to a second class of interest that meets certain requirements.[116] Under the regulations, the second class of interest must be held by persons who are treated as limited partners under the tests described above.[117] A person who is not treated as a limited partner as a result of the personal services test is not eligible for the two classes of interest exception.

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[114] Prop. Reg. §1.1402(a)-2(h)(2)(iii).

[115] Prop. Reg. § 1.1402(a)-2(h)(5).

[116] The proposed regulations define a class of interest as “an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in IRC § 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest. Prop. Reg. § 1.1402(a)-2(h)(6)(i).

[117] The proposed regulation applies to “Limited partners within the meaning of paragraph (h)(2).” Prop. Reg. § 1.1402-2(h)(3). Under Prop. Reg. § 1.1402-2(h)(2), all partners are limited partners unless they meet one of the liability test, the authority test, or the participation test. It is unclear whether a partner who fails the service test (*i.e.*, is a service partner in a service partnership) but otherwise does not have personal liability or authority or participate for 500 hours a year would be a “limited partner within the meaning of paragraph (h)(2).” It appears that because Prop. Reg. § 1.1402-2(h)(5) provides that “an individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section” that a service partner in a service partnership would not be treated as a limited partner.

• <u>The Single Class of Interest Test</u>: An individual who is not treated as a limited partner solely by virtue of participating for more than 500 hours in a year, may, nonetheless, be treated as a limited partner if that individual's rights and obligations by virtue of owning that interest are identical to the rights and interests of other partners who have substantial continuing interests in the partnership and who are treated as limited partners.[118] This provision would prevent a member of an LLC with one class of interest from being treated as a general partner simply by contributing 500 hours.

In order for the general partner to be able to take advantage of these rules, the limited partners must own a "substantial, continuing interest in a specific class of partnership interest."[119] The 1997 Regulations provide that the ownership of 20% of a particular class of interest will be considered substantial.[120] Under the 1997 Regulations, the distributive share attributable to a partnership interest of an individual who would otherwise be considered a general partner will be treated as the distributive share of a limited partner if that partnership interest is identical to the interest held by "limited partners within the meaning of paragraph (h)(2)."[121] Thus, to determine the applicability of the class of interest exceptions, one must determine who a "limited partner" is and what an "identical interest" is.

The 1997 Regulations suggest that the only partners who will be considered as "limited partners" are individuals. The interests being considered are interests held by "limited partners within the meaning of paragraph (h)(2)."[122] Proposed Regulation§1.1402-2(h)(2) refers to individuals being treated as limited partners. A rigorous reading of the regulations would suggest that the limited partners owning the substantial continuing interest must be individuals. There is no policy reason for the requirement that the "limited partners" be individuals, but planners should carefully consider whether they will be able to take advantage of the 1997 Regulations with limited partners which are entities.

Section 935 of the Taxpayer Relief Act of 1997[123] provided, "No temporary or final regulation with respect to the definition of a limited partner under Section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998." Although the moratorium expired in 1998, no further regulations or legislation has been adopted. On June 10, 2003, Lucy Clark, a national issue specialist in IRS's Examination Specialization Program, stated that taxpayers may continue to rely on the 1997 Regulations. "If the taxpayer conforms to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes"[124]

Under the 2005 JCT Report, the exception for limited partners would be removed and present-law rule for general partners generally applies to any tax partner for determining net earnings from self-

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[118] Prop. Reg. § 1.1402-2(h)(4).

[119] Prop. Reg. § 1.1402-2(h)(3)(i); Prop. Reg. § 1.1402-2(h)(4)(i).

[120] Prop. Reg. § 1.1402-2(h)(6)(iv).

[121]Prop. Reg. § 1.1402-2(h)(3)(i); Prop. Reg. § 1.1402-2(h)(4)(i).

[122] Prop. Reg. § 1.1402-2(h)(3)(i); Prop. Reg. § 1.1402-2(h)(4)(i).

[123] Pub. L. No. 105-34, 111 Stat 788.

[124] Alison Bennett, Taxpayers Can Rely on Proposed Regulations For LLC Self-Employment Taxes, Clark Says, 114 BNA's Daily Tax Report (Friday, June 13, 2003) Page G-3.

employment. Thus, all partners are subject to self-employment tax on their distributive share (whether or not distributed) of partnership income or loss. As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner (other than a partner in a personal service business,)[125] such as certain rental income, dividends and interest, certain gains, and other items. Under the proposal, in the case of a service partnership, all of the partner's net income from the partnership is treated as net earnings from self-employment. If, however, any partner (regardless of whether he or she is a general partner, limited partner, or neither a general nor limited partner, such as a limited liability company member) does not materially participate in the trade or business of the partnership, a special rule provides that only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment. Thus, some general partners would be subject to self-employment tax. Under the proposal, for purposes of employment tax, an S corporation is treated as a partnership and any shareholders of the S corporation are treated as general partners. The 2006 JCT Report focuses on service-based passthrough businesses,[126] proposing that the rules applicable to general partners be applied to shareholders in S corporations.

On March 15, 2007, the American Bar Association Section of Taxation released comments on the JCT recommendations for the treatment of both tax partnerships and S corporations. When released, such comments should be available at https://www.abanet.org/tax/pubpolicy/2007/070315jctreport.pdf.

In December 2009, the General Accountability Office (GAO) released a report entitled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules"[127] a portion of which was

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[125] The proposals in the 2005 JCT Report (on pages 99-100) were as follows:

> Under the proposal, the present-law rule for general partners generally applies to any partner for determining net earnings from self-employment. Thus, all partners are subject to self-employment tax on their distributive share (whether or not distributed) of partnership income or loss. As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service partnership, all of the partner's net income from the partnership is treated as net earnings from self-employment. A service partnership is 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)).
>
> If, however, any partner (regardless of whether he or she is a general partner, limited partner, or neither a general nor limited partner, such as a limited liability company member) does not materially participate in the trade or business of the partnership, a special rule provides that only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment. Thus, some general partners who would be subject to self-employment tax on their distributive share of partnership income under present law will be subject to tax only on reasonable compensation from the partnership under the proposal.

[126] For this purpose, a service-based passthrough business is a tax partnership or S corporation, 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 the definition in IRC § 448(d)(2)).

[127] GAO-10-195, Noncompliance with S Corporation Tax Rules, December 2009.

entitled, “Inadequate Wage Compensation to S Corporation Shareholders Creates Employment Tax Noncompliance, Which Could be Addressed through Legislative or Administrative Changes.” and which concluded by setting forth options to legislatively and administratively increase the amount of employment tax collected from S corporation shareholders.[128] In addition, there has been increasing pressure on S corporations with a single shareholder to increase withholding.[129]

In light of this it is not surprising that the American Jobs and Closing Tax Loopholes Act of 2010 (ACELA), which was considered by Congress in early to mid-2010, contained provisions that addresses the employment/self-employment status of S corporation shareholders and limited partners.[130] Under the ACELA, a shareholder's share of income from a trade or business of an S corporation would have been taken into account in determining NESE if (1) the S corporation is engaged in a professional service business that is principally based on the reputation and skill of three or fewer employees or (2) the S corporation is a partner in a professional service business. Proposed IRC §1402(m). The shareholder's NESE would have been limited to the same types of income as would be applicable to a partnership.[131] A shareholder's NESE would include the distributive share of certain family members.

A professional services business would have been defined as “any trade or business if substantially all of the activities of such trade or business involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.”

In determining whether an S corporation shareholder would have been subject to the new rules, there are two distinct sets of circumstances that would have been relevant: (1) an S corporation based on the skill or reputation of three or few employees, and (2) an S corporation that is a partner in personal services partnership. The first would have been the unusual test of “the reputation and skill of

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[128] Among the legislative options presented in the GAO study were “Make Net Business Income Subject to Employment Taxes,” Make Net Business Income for Service Sector Businesses Subject to Employment Taxes, “Make Net Business Income for Majority Shareholders Subject to Employment Taxes,” and “Make Payments to Active Shareholders Subject to Employment Tax,” and “Make Payments to Active Shareholders Up to a Dollar Tolerance Subject to Employment Tax.” In addition, the GAO discussed another option, “Retain Character of Income Between Entities” under which income that flows from a partnership to an S corporation will retain its self-employment tax character until it is passed to an individual shareholder.

[129] See, e.g., Fact Sheet 2008-25, August 2008 (http://www.irs.gov/newsroom/article/0,id=200293,00.html) (“Subchapter S corporations should treat payments for services to officers as wages and not as distributions of cash and property or loans to shareholders ... . The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate.”); *David E. Watson, P.C. v. U.S.*, 714 F. Supp. 2d 954, 2010-1 U.S. Tax Cas. (CCH) P 50444, 105 A.F.T.R.2d 2010-2624 (S.D. Iowa 2010) (sustaining an IRS determination that a sole shareholder of an S corporation should treat $130,730 of the “dividend” payments for 2002 and $175,470 for 2003 as compensation).

[130] Section 413(a) of the AJCLTA, H.R. Rep. No. 111-4213. As of September 15, 2010, the fate of the AJCLTA is uncertain.

[131] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the “American Jobs And Closing Tax Loopholes Act of 2010,” JCX-29-10 (May 28, 2010) at page 292 (“As under the present-law self-employment tax rules in the case of a trade or business carried on by a partnership, certain items of income or loss are excluded from net earnings from self-employment of an S corporation shareholder under the provision, such as certain rental income, dividends and interest, and certain capital gains and losses.”).

three or fewer employees." Apparently, the test was not going to refer to the number of owners, the participation of the celebrated employees, or possibly even whether the reputation is in the area in which the employee is serving. Particularly in areas such as performing arts and athletics, if a similar provision is enacted, it may become important not to make the celebrated person an employee. The obvious target of the "reputation and skill" would have been the closely held professional practice, even where there are several employees or shareholders. The Joint Committee commentary appears to confirm that the persons whose reputation is considered must be employees.[132] The second test would appear to have been designed to avoid the circumstances in which an individual would employ an S corporation to reduce NESE from a professional services partnership by interposing the S corporation, paying himself or herself a salary subject to employment taxes and distributing the balance as dividends not subject to SECA. While such an arrangement would have been covered by this provision, the provision would also have covered a more widely held S corporation if the S corporation's income was largely based on professional services income from the partnership.[133]

With respect to partnerships, the statute would have denied the exclusion from NESE available to "limited partners" with respect to professional services business conducted by partnerships. This section appears to codify and expand a provision of the proposed regulations issued in 1997 addressing a similar provision. Under the proposed regulations,[134] a person providing services to a "personal services" partnership would not be entitled to be treated as a limited partner, and, thus, would be required to include his or her distributive share in income.[135]

While it appeared that, pending other guidance, the 1997 proposed regulations would provide a safe harbor, a February 9, 2011, Tax Court case has reintroduced some uncertainty. *Renkemeyer*

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[132] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "American Jobs And Closing Tax Loopholes Act of 2010," JCX-29-10 (May 28, 2010) at page 292 ("It is intended that an employee include an individual who is considered an employee for Federal tax purposes.").

[133] An example in Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the **"**American Jobs And Closing Tax Loopholes Act of 2010,**"** JCX-29-10 (May 28, 2010) at page 292 explains this:

> For example, assume that an S corporation's stock is owned by a group of architects. The S corporation becomes a partner in a partnership that is formed to enter a competition to design a particular building. The other partners are architects that are not owners of the S corporation. The partnership wins the competition and the partners, including shareholders of the S corporation, perform architectural services for 18 months in connection with the construction of the building that was the subject of the competition. At the same time, the S corporation provides architectural services with respect to the design and construction of several other buildings. At the end of the 18 months, the partnership is terminated. The S corporation is not a disqualified S corporation because substantially all its activities are not performed in connection with the partnership.

[134] Prop. Treas. Reg. §1.1402(a)-2, 62 Fed. Reg. 1702 (January 13, 1997). However, section 935 of Taxpayer Relief Act of 1997 (Pub. L. No. 105-34), Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

[135] The proposed rules for determining who is a general partner for purposes of determining the SECA treatment of partners use similar tests to determine whether a partnership is a "service partnership." Under Prop. Reg. §1.1402(a)-2(h)(6) partners in a "service partnership" would be treated as "general partners" for purposes of determining NESE. The new S corporation expands the definition of "professional service business" beyond that of "service partnership" to add several new categories of services: lobbying, performing arts, athletics, investment advice or management, or brokerage services.

v. Commissioner[136] dealt with the treatment of the distributive share of income from a law firm organized as a Kansas LLP for purposes of the determination of NESE and other purposes. The case dealt with the distributive shares of a law firm known as *Renkemeyer, Campbell & Weaver, LLP v. Commissioner* (for 2004) and *Renkemeyer, Campbell, Gose & Weaver LLP* (for 2005). For 2004, the firm claimed its written partnership agreement--which the law firm could not produce--provided for allocations of 30% each to three individual partners and 10% by an S corporation owned by an ESOP of which the partners were the beneficiaries. Despite this and the fact that the ESOP did not have any capital interest in the partners, the law firm made a special allocation in 2004 of 87.557% of its income to the ESOP. The Service reallocated the income in accordance with percentages in the partnership agreement (30% to each individual and 10% to the ESOP). The Tax Court, after reviewing the law on special allocations, found the special allocation of 87.557% of the income to the ESOP to be invalid and upheld the Service's determination.

Of greater interest is Judge Jacobs' extensive discussion of the treatment of the individual partners' distributive shares of income in 2004 and 2005. As discussed above, the distributive share of a partner in a partnership engaged in a trade or business is generally included in NESE, but the distributive share of a "limited partner in a limited partnership" is not. The partners in the law firm asserted that they should be treated as "limited partners" for purposes of IRC §1402(a)(13), because "(a) their interests are designated as limited partnership interests in the law firm's organizational documents, and (b) his and Messrs. Campbell's and Weaver's interests in the law firm enjoy limited liability pursuant to Kansas law." While the court correctly noted that a LLP is a general not a limited partnership--which might in itself have resolved the issue in favor of the Service--the court chose to make a more thorough analysis of what a "limited partner" is. The court discussed the 1997 Regulations--which would have held the partners' interests as general partner interests under either the authority test or the personal services exception--and the moratorium, and determined that the moratorium suggested that Congress, not the Department of Treasury, should resolve the question of who is a limited partner in light of the development of LLCs and LLPs. The court apparently felt that as neither Congress nor the Department of Treasury has acted, it needed to analyze the status of "limited partner" under the legislative history of IRC §1402(a)(13). The court noted that in the 1977 enactment Congress has stated that the exclusion of limited partners in limited partnerships was to "exclude for coverage purposes certain earnings which are basically of an investment nature."[137] Based on this history, the court held:

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[136] *Renkemeyer, Campbell & Weaver, LLP v. C.I.R.*, 136 T.C. 137, Unempl. Ins. Rep. (CCH) P 14768C, Tax Ct. Rep. (CCH) 58543, Tax Ct. Rep. Dec. (RIA) 136.7, 2011 WL 490873 (2011), see also Amy Eliott, Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes, 2011 TNT, p. 1244, Tax Notes Doc 2011-5140, or 2011 TNT 48-3 (Mar. 14, 2011) and Sheldon Banoff, Renkemeyer Compounds the Confusion in Characterizing Limited and General Partners--Part 1, Journal of Taxation, December 2011 at page 306 (with a second part to be published). See also, Sullivan, Economic Analysis: Renkemeyer Annual Cost To Partners Could Exceed $1 Billion, Tax Notes Doc 2011-56602011 TNT 55-2 (Release Date: March 17, 2011) (Noting that for 2008 the Statistics of Income Bulletin show "$43 billion of income from partnerships providing 'professional, scientific, and technical services' was allocated to individual (that is, noncorporate) limited partners" and that "the lion's share of business in the professional, scientific, and technical services category is attributable to legal and accounting services. The remainder is attributable to partnerships performing architectural, engineering, specialized design, advertising, and consulting services." From this the author concludes that to the extent Renkemeyer constitutes a change in the law, it would produce $1.22 billion in additional revenue.).

[137] Opinion at page 22 citing H.R. Rep. No. 95-702 (Part 1), at 11 (1977) (language emphasized in the opinion).

> The insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

136 T.C. No. 7 at page 22. The court went on to determine that as the income of the law firm came from the efforts of the partners, the partners' distributive share of income constituted NESE.

The opinion calls into question whether the 1997 Regulations have applicability to members in LLCs. Further, it may raise the question of whether even traditional limited partners in state law limited partnerships are considered "limited partners" for purposes of IRC §1402(a)(13). If, as the opinion suggests, "limited partner" must be understood by reference to whether the partner performs services, the opinion might be broadly read to hold that a limited partner under state law who performs services is not a "limited partner" for purposes of IRC §1402(a)(13). The better reading, in light of the fact that IRC §1402(a)(13) expressly considers a limited partner who performs services and the legislative history expressly permits a person to be both a general and a limited partner.[138] As such, a better interpretation may be that the opinion (and the definition of "limited partner in a limited partnership" in the opinion) is limited to partnerships other than state law limited partnerships.

The *Renkemeyer* analysis was applied to members of an LLC in *RI ether v. United States*,[139] in which a husband and wife were members of, and worked for, a diagnostic imaging LLC. For 2006, they each took "wages" in connection with which they each received a Form W-2 from the LLC, while simultaneously treating themselves as partners for the rest of the LLC's earnings, by issuing themselves Schedules K-1, claiming that they had no self-employment income. The income at issue is not the income they treated as "wages," but the income they treated as their distributive share of partnership income. The court, citing Rev. Rul. 69-184,[140] held that all the LLC's income (both "wages" and other income) should be treated as self-employment income.[141] The court went on state, "Plaintiffs are not members of a limited partnership, nor do they resemble limited partners, which are those who 'lack management powers but enjoy immunity from liability for debts of the partnership.' (citation to

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138 H.R. Rep. No. 95-702 (Part 1), at 40 (1977) ("Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.").

139 919 F.Supp.2d 1140 (D. N.M. 2012).

140 1969-1 C.B. 256.

141 Treas. Reg. § 1.1402(a)-2(g) (which was adopted in 1963 (6691) and updated in 1974 (T.D. 7333) and apparently has not been updated to reflect the adoption of IRC § 1402(a)(13) in 1977, holding "The net earnings from self-employment of a partner include his distributive share of the income or loss, described in section 702(a)(9), of the partnership of which he is a member, irrespective of the nature of his membership" and *Ding v. Comm'r*, 74 T.C.M. (CCH) 708 [1997 RIA TC Memo ¶97,435] at 2 (1997).

Renkemeyer omitted)" Thus, whether Plaintiffs were active or passive in the production of the LLC's earnings, those earnings were self-employment income."[142]

The following is a sampling of cases in which IRC § 1402(a)(13) has been invoked to determine a taxpayer's liability for employment taxes:

Case	Year	FOE	Result	Comments
Vincent J. Castigliola, et ux., et al., TC Memo 2017-62	2017	PLLC (atty)	NESE	Members were not limited partners, by necessity at least one member must occupy role analogous to general partner. Members received guaranteed payments but balance was also NESE.
Stephen P. Hardy, et ux., TC Memo 2017-16	2017	PLLC (MD)	Ex-cluded from NESE	Taxpayer's income from a medical center/LLC-partnership in which he held minority interest and for which he performed surgeries was excluded from NESE because taxpayer: (i) wasn't involved in LLC's operations, (ii) received his distributions based on fees patients paid for center's use, and (iii) was paid separately for his surgeon fees The court held that the taxpayer received subject distributions in an investor capacity, and such distributions did not constitute NESE.
CCA 201640014	2016	LLC	NESE	See discussion below.
David H. Methvin, T.C. Memo. 2015-81	2015	Work-ing in-terests	NESE	"[W]orking interest owners and well operator created a pool or joint venture for operation of the wells. Accordingly, petitioner's income from the working interests was income from a partnership of which he was a member under the broad definition of 'partnership'". Thus, taxpayer liable for SECA tax. See also, Cokes v. Commissioner, 91 T.C. 222 (1988); Perry v. Commissioner, T.C. Memo. 1994-215; and Moorhead v. Commissioner, T.C. Memo. 1993-314 to same effect.

[142] 919 F. Supp. 2d 114__).

Case	Year	FOE	Result	Comments
CCM 201436049	2014	LLC	NESE	"Management Fund" LLC paid "wages" to partners (members) which it argued constituted reasonable compensation and treated all of its partners as limited partners excluding distributive share from NESE. Citing Renkemeyer and Riether, Chief Counsel held "Partners' earnings are not in the nature of a return on a capital investment, even though Partners paid more than a nominal amount for their Units. Rather, the earnings of each Partner from Management Company are a direct result of the services rendered on behalf of Management Company by its Partners. . . Management Company cannot change the character of its Partners'distributive shares by paying portions of each Partners' distributive share as amounts mislabeled as so-called "wages." Management Company is not a corporation and the "reasonable compensation" rules applicable to corporations do not apply."
Lauren A. Howell, et vir., TC Memo 2012-303	2012	LLC	NESE	Wife performed minimal services for LLC in which she and husband were owners. Payments were characterized as guaranteed payments so even if she were a "limited partner" she would have NESE under IRC § 1402(a)(13).
Riether v. U.S., 919 F. Supp. 2d 1140 (Dist N.M. 2012)	2012	LLC	NESE	Merely stating the income of an LLC is "unearned income" does not exclude it from NESE. Although the taxpayers issued W-2's for some payments, the court held that they could not be employees of the LLC and and the distributive share was included in NESE.
Tony L Robucci, et al., TC Memo 2011-19	2011	LLC	NESE	The court never reached the "limited partnership" status of taxpayer's interest because it disregarded the entire structure.
Renkemeyer, Campbell & Weaver, LLP, et al., 136 TC 137	2011	LLP	NESE	IRC § 1402(a)(13) intended to ensure that individuals who merely invest in partnership and are not actively participating in the partnership's business operations do not receive credits toward Social Security.
Martin G. Plotkin, TC Memo 2011-260	2011	LP	NESE	Taxpayer was not a partner in the limited partnership although, as a result of his work, he was paid by the limited partnership ("which he attempted to disguise using various entities").

Case	Year	FOE	Result	Comments
Matthew W. Norwood, et ux., TC Memo 2000-84	2000	GP	NESE	Taxpayer's interest was a general partner and the fact that taxpayer spent a minimal amount of time engaged in the operations of the partnership irrelevant to the determination
Hough v. U.S., 162 F3d 1151 aff'g William T. Hough, et ux., TC Memo 1997-361	1997 - 1998	LP		Limited partnership losses cannot be used to reduce NESE because such losses are not income or losses from self-employment as a result of IRC § 1402(a)(13)
Paul B. Ding, et ux., TC Memo 1997-435	1997	Sole Prop.	NESE	Loss from S corporation could not offset NESE from sole proprietorship

Chief Counsel Advice 201640014 (September 30, 2016), in considering whether an individual (Partner) who was franchisee, operating manager, president, majority owner, and CEO of an LLC taxed as a partnership would not be treated as a limited partner for purposes of IRC §1402(a)(13). The LLC made guaranteed payments to the Partner, but treated the Partner as a limited partner for purposes of treating Partner's distributive share of operating profits as not being NESE. The LLC argued that the Partner's income from the LLC should be bifurcated for self-employment tax purposes between Partner's (1) income attributable to capital invested or the efforts of others, which is not subject to self-employment tax, and (2) compensation for services rendered, which is subject to self-employment tax. In support of this position, the LLC cited a case[143] recharacterizing deductible "salary" paid by a C corporation to its shareholder as nondeductible dividends because the amount of salary should be determine by treating a certain amount of the distribution by a C corporation as a reasonable return on capital rather than as compensation.

The CCA, while noting the existence of the 1997, regulations, nonetheless determined, based on *Renkemeyer* and *Riether*, that all of the individual's income from the LLC, both wages and distributive share constituted NESE. The CCA declined to consider the partner's arguments that either: (1) only an amount constituting "reasonable compensation" (i.e., the guaranteed payments) should be included as NESE, or (2) that an amount equal to a "reasonable return on investments" should be deducted from the partner's distributive share.

D. Recent Tax Proposals

Several, Federal tax proposals implicating or relying on disparate treatment (and definitions) of compensatory and non-compensatory income:

1. Tax Reform Act of 2014 (Camp Proposal)

[143] *Brinks Gilson & Lione a Professional Corporation v. Commissioner,* T.C. Memo 2016-20.

The proposed Tax Reform Act of 2014 modified the treatment of compensatory income in two ways.

It proposed modifying the determination of net earnings from self-employment under the SECA tax by adding the shareholder's pro rata share of income from S corporations, repealing the exception for limited partners, providing a new deduction related to non-labor income, and providing a new 100-percent deduction for individuals who do not have material participation (defined under the passive loss rules).[144] In addition, the proposal provided for a deduction from NESE that reduced net earnings from self-employment by a percentage that is derived from the historical portion of U.S. gross domestic product that represents income other than labor income. The deduction does not depend in any case on the type or nature of any particular item of income or earnings, but rather is calculated under a formula derived by reference to historical non-labor income.

The proposal also called for a special rate to apply to "qualified domestic manufacturing income" (domestic manufacturing receipts [receipts derived from 1) any lease, rental, license, sale, exchange, or other disposition of tangible personal property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States; or (2) in the case of a taxpayer engaged in the active conduct of a construction trade or business, construction of real property performed in the United States by a taxpayer in the ordinary course of such trade or business if such real property is placed in service after December 31, 2014.] but domestic manufacturing gross receipts also do not include any gross receipts which are properly allocable to the taxpayer's net earnings from self employment (i.e., amounts received from partnerships and S corporations constituting labor income (thus, 30% of the income of partnerships or S corporations which are treated as domestic manufacturing receipts).

2. House Blueprint, H.R. 116, and S. 707

On June 24, 2016, the House Ways and Means Committee report entitled "A Better Way Forward on Tax Reform" (commonly referred to as the "Blueprint," available at https://waysandmeans.house.gov/taxreform/ provides for the reduction of the tax rate on corporations (and income from partnerships and sole proprietorships) to 20% (the "Business Rate") and reduces the tax rate for the top tax bracket for what it refers to as "families and individuals" to 33% (the "Families and Individuals Rate").

The Blueprint provides:

> Millions of small and closely held businesses are organized as pass-through entities – such as partnerships and S corporations – that are taxed under the individual rate structure rather than at the corporate rate. These businesses often compete directly with businesses that are subject to the corporate tax, with the differential in tax treatment creating potential distortions and inequities. As discussed below, the Tax Reform Blueprint will create a new business tax rate for small businesses that are organized as sole

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[144] IRC §469(h).

proprietorships or pass-through entities, which means that small business income will no longer be subject to the top individual tax rate – not even the lower 33 percent top rate in this Blueprint – thus leading to a maximum tax rate of 25 percent on small business income. This approach to the tax treatment of business income will build on concepts developed by Rep. Vern Buchanan of Florida in his Main Street Fairness Act (H.R. 5076).[145]

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[145] Blueprint page 17. The current version of the Main Street Fairness Act (H.R. 116 (introduced January 3, 2017) and S. 707 (introduced March 23, 2017), 115th Cong., First Sess.) would add a new subsection to IRC § 1: reading as follows:

> Qualified business income.—
>
> (1)In general.— If a taxpayer has qualified business income for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—
>
> (A)a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of—
>
> (i)taxable income reduced by the sum of net capital gain plus qualified business income, or
>
> (ii)the amount determined under clause (i) plus so much of qualified business income that, when added together, would not be taxed at a rate greater than the maximum rate in effect under section 11(b),
>
> (B) tax on qualified business income reduced by the amount of qualified business income on which a tax is determined under subparagraph (A) (if any), determined under section 11 for the taxable year by treating qualified business income as taxable income of a corporation, plus
>
> (C) a tax on net capital gain, computed as if subsection (h) imposed a tax on net capital gain.
>
> (2) Qualified business income defined.—For purposes of this subsection—
>
> (A) Qualified business income.—The term "qualified business income" means all items of income, deduction, loss, or credit properly attributable to the taxpayer from the active conduct of a trade or business in which—
>
> (i) in the case of a partnership, the taxpayer holds a capital or profits interest,
>
> (ii) in the case of an S corporation, the taxpayer is a shareholder,
>
> (iii) in the case of a sole proprietorship or an entity otherwise disregarded as separate from its sole owner, the taxpayer is the sole owner, and
>
> (iv) in the case of a trust or estate, the taxpayer is a beneficiary.

This change is directed exclusively at income tax. Under the Blueprint regime, a portion of the income equal to reasonable compensation to individual owners will be taxed to those owners under the Individual and Families Rate, with the balance taxable under the Business Rate:

> Under this new approach for taxing small businesses, sole proprietorships and pass-through businesses will pay or be treated as having paid reasonable compensation to their owner-operators. Such compensation will be deductible by the business and will be subject to tax at the graduated rates for families and individuals. The compensation that is taxed at the lowest individual tax bracket rate of 12 percent effectively will further reduce the total income tax burden on these small businesses and pass-through entities.[146]

The Blueprint suggests that another task force is looking at health care, but that the Ways and Means Committee, while continuing tax incentives for retirement savings, will "examine existing tax incentives for employer-based retirement and pension plans in developing options for an effective and efficient overall approach to retirement savings." In addition, families and individuals will be able to deduct 50% of their "investment income" (net capital gains, dividends, and interest income, leading to basic rates of 6%, 12.5%, and 16.5% on such income. How the current interplay between employment (and self-employment) taxes and income taxes will be affected by these changes remains to be seen, but, presumably, the amounts constituting "reasonable compensation" will be subject to the general individual rate and continue to be subject to SECA or NESE taxes.

The following table demonstrates the comparative rates under current law, the general individual rate, and the "business and pass-through" rate applicable to income (other than investment income [capital gains, dividends, and interest] and amounts constituting "reasonable compensation") of individuals from sole proprietorships or pass-through entities such as partnerships, LLCs taxed as partnerships, and S corporations:

> (B) Net capital gain.— Such term shall not include any item taken into account in determining net capital gain.
>
> (C) Exception for financial services income of partnerships.— In the case of a taxpayer who holds a capital or profits interest in a partnership, such term does not include financial services income (as defined in section 904(d)(2)(D)).
>
> (3)Limitation.—Paragraph (1) shall only apply to a taxable year in which the maximum rate of tax under this section exceeds the maximum rate of tax under section 11.
>
> (4)Net capital gain.— For purposes of this subsection, the term "net capital gain" has the meaning given to such term by subsection (h).
>
> (5)Regulations.— The Secretary shall issue such regulations or other guidance as may be necessary to carry out the purposes of this subsection.

[146] Blueprint page 23. The Blueprint goes on to make makes the following comment on employment and self-employment tax "Generally, the tax system should use the same definition for taxable compensation of employees as it does for compensation employers may deduct. Families and individuals generally will include in income any compensation received related to employment or self-employment."

<table>
<tr><th>Current Rate</th><th>Business and Pass-Through Income Rate</th><th>Dividends, Capital Gains, and Interest</th><th>General Individual Rate</th></tr>
<tr><td>0%</td><td rowspan="2">0%/12%</td><td rowspan="2">0%/6%</td><td rowspan="2">0%/12%[147]</td></tr>
<tr><td>15%</td></tr>
<tr><td>25%</td><td rowspan="5">25%</td><td rowspan="2">12.5%</td><td rowspan="2">25%</td></tr>
<tr><td>28%</td></tr>
<tr><td>33%</td><td rowspan="3">16.5%</td><td rowspan="3">33%</td></tr>
<tr><td>35%</td></tr>
<tr><td>39.6%</td></tr>
</table>

3. Bring Businesses Back Tax Reform Act (H.R. 1425)

On March 8, 2017 a second alternative, the Bring Businesses Back Tax Reform Act, was introduced. Rather than imposing corporate taxes this act would impose a new tax regime on income from sole proprietorships, partnerships, and S corporations in which the taxpayer materially participates. It does not have an exclusion for reasonable compensation, but is limited to $1,000,000 of income per sole proprietor, partnership, or S corporation.[148]

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[147] According to the Blueprint "As described below, the new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0 percent bracket. As a result, taxpayers who are currently in the 10- percent bracket always will pay lower taxes than under current law."

[148] A new subsection (j) would be added to IRC § 1 providing:

(j) MAXIMUM RATE ON QUALIFIED SMALL BUSINESS INCOME.—

(1) IN GENERAL.—If a taxpayer has qualified business income for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—

(A) a tax computed at the rates and in the same manner as if this subsection had not been enacted on taxable income reduced by qualified business income,

(B) 12 percent of so much of the qualified business income of the taxpayer as does not exceed $150,000, plus

(C) 25 percent of so much of the qualified business income of the taxpayer as exceeds the amount on which tax is determined under subparagraph (B).

(2) QUALIFIED BUSINESS INCOME.—

(A) IN GENERAL.—The term 'qualified business income' means so much of the following of the taxpayer as does not exceed $1,000,000:

(i) Gross earnings derived by an individual from any active trade or business carried on by such individual, less the deductions allowed by the subtitle which are attributable to such trade or business.

4. 2017 Tax Reform for Economic Growth and American Jobs

On April 26, 2017, the Administration released the "2017 Tax Reform for Economic Growth and American Jobs (The Biggest Individual And Business Tax Cut In American History)" reproduced here in its entirety:

Goals For Tax Reform

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families – especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

Individual Reform

- Tax relief for American families, especially middle-income families:

  o Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%

  o Doubling the standard deduction

  o Providing tax relief for families with child and dependent care expenses
- Simplification:

  o Eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers

  o Protect the home ownership and charitable gift tax deductions

  o Repeal the Alternative Minimum Tax

  o Repeal the death tax
- Repeal the 3.8% Obamacare tax that hits small businesses and investment income

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(ii) The taxpayer's distributive or pro rata share qualified pass-through income. Such term shall not include any amounts, or any distributive or pro rata share, attributable to capital gains, interest, dividends, and royalties.

(B) QUALIFIED PASS-THROUGH INCOME.—The term 'qualified pass-through income' means, in the case of a partnership or S corporation, so much of the income of the partnership computed under section 703, or income of the S corporation computed under section 1363, as does not exceed $1,000,000 and is designated as such (at such time and in such form and manner as the Secretary shall prescribe) and allocated by the partnership or S corporation. Any income so designated shall be allocated amongst partners or shareholders in the same proportion as distributive or pro rata shares of income or loss are allocated. Such term shall not include any capital gains, interest, dividends, or royalties.

(3) SPECIAL RULES.—

(A) MATERIAL PARTICIPATION.—Paragraph (1) shall not apply with respect to any income attributable to a trade or business in which the taxpayer does not materially participate.

(B) COORDINATION WITH CAPITAL GAINS.—This subsection shall be applied before the application of subsection (h).

Business Reform

- 15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

Process

- Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides massive tax relief, creates jobs, and makes America more competitive – and can pass both chambers.

5. Unified Framework for Fixing Our Broken Tax Code

On September 27, 2016 the administration and certain Republican Congressional leaders released a Unified Framework for Fixing Our Broken Tax Code (the "Framework"), which, in keeping with the terse approach to tax legislation that has characterized all tax reform efforts after 2014, provided general recommendations, including a 20% corporate rate, elimination of the alternative minimum tax, and expensing of certain capital investments. With respect to business income from pass-throughs, the Framework imposes a 25% top rate (as opposed to the top 35% rate on individuals), but provides: "The framework contemplates that the committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate."

II. Compensatory Income (and Deductions)

A. What is Compensatory (and Non-Compensatory) Income?

1. Compensatory Income.

For purposes of this presentation, "compensatory income" may be thought of as income attributable to services. It may be termed "labor income,"[149] "non-passive income," or compensatory income. For purposes of deductions by the payor, the income must constitute "reasonable compensation" for the services performed.[150]

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[149] The Camp Proposal describes this sort of income as "labor income" without defining the term. See, Joint Committee on Taxation, Technical Explanation, Estimated Revenue Effects, Distributional Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code (JCS-1- 14), September 2014. This document can also be found on our website at www.jct.gov. See also 2012 CBO study.

[150] IRC § 61(a)(1) requires the inclusion of "[c]ompensation for services, including fees, commissions, fringe benefits, and similar items; "For owners of corporations, the amount of labor income subject to the FICA tax must represent "reasonable compensation"; in other words, it should bear some resemblance to the market wage for their services." in income without respect to whether such compensation is "reasonable." In contrast, IRC § 162(a)(1)

2. Non-Compensatory Income.

Non-Compensatory Income may be described as income other than Compensatory Income, but in many circumstances it is described without any reference to services or Compensatory Income. For example, it is often referred to as "capital income" or "income on capital." Such definitions suggest that income will not be considered noncompensatory if it is derived from services, raising the interesting question of whether income derived by an individual from the services of others should be considered non-compensatory. Under some of the proposed tax reform measures it is described as "business income" or "qualified business income," and the limited explanation that has accompanied the proposed legislation suggests that, of course, business income would not include amounts constituting compensation, which amounts would be taxed at the higher rates applicable individuals and families.

B. Indirect Methods of Distinguishing Compensatory from Non-Compensatory Income

In distinguishing compensatory from non-compensatory income, there are three perspectives from which the determination can be made: (1) by looking at the individual reporting the income, (2) by looking at source of the income, or (3) by looking at the role of the individual in deriving the income. An example of income treated as compensatory solely by reference to the individual deriving the income would be the rule that a sole proprietor will treat all but a few forms income from a trade or business the sole proprietor conducts as compensatory.[151] An example of income that is treated as compensatory determined solely by reference to the source of the income are those provisions dealing with personal or professional service organizations, the income of which is presumptively or conclusively treated as compensatory. Finally, there are circumstances in which the compensatory nature of the income will involve an evaluation of both the nature of the source of the income and the involvement of the taxpayer in the activity in which the income is produced.

1. Active v. Passive Income/Deductions

One of the proposed methods of distinguishing compensatory from non-compensatory income under both the 2012 CBO study and the Camp Proposal treat passive income as non-compensatory and non-passive income as compensatory.

2. Limited Partner v. General Partner

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only allows a business deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered;" The 2012 CBO Study at page v suggests that "the amount of labor income subject to the FICA tax must represent "reasonable compensation"; in other words, it should bear some resemblance to the market wage for their services." I am unaware of any situation in which an employee took the position that some of her wages should be excluded from FICA taxes because they exceed reasonable compensation.

[151] IRC § 1402(a).

As discussed above, much ink has been spilled and many trees have given their lives to the determination of compensatory or noncompensatory nature of income derived from owners of interests in unincorporated organizations. The case law and proposed regulations have considered both the statutory provisions governing and the historical context of the organizations generating the income.

3. The source of the income

As noted above, the compensatory nature of income may turn on the source of the income. Income from the performance of personal services is compensatory while income from the exploitation of capital is non-compensatory. Of course all capital was created by personal services and many personal service produce something that might be considered capital. Consider the apparent ambivalence in the tax system reflected in the distinction between the treatment of patents and copyrights.

4. An simple fraction

The Camp Proposal mandated that labor income and non-labor income would, except in the case of professional services organizations would be apportioned based upon a percentages of income generated by labor or capital in the entire economy. The inherent problems with such a determination may be outweighed by the simplicity of administration.

5. Reasonable Compensation

To the extent that "reasonable" compensation can be determined with any facility and accuracy, it would be an effective way of determining labor income, with the balance being considered non-compensatory income.

6. Income from Capital Distinguished

7. Non-Labor Income

III. Contexts In Which the Treatment of Income (and Deductions) as Compensatory Makes A Difference

A. Federal Income Taxation

B. Employment Taxation

C. Transfer Taxation

IV. Methods of Distinguishing Compensatory Income from Other/Non-Compensatory Income

Many of these methods arise where there is an issue for segregating Compensatory Income from Capital Income discussed in the next section.

A. Reasonable Compensation Included

B. Return on Capital Excluded

C. Certain Types of Income Excluded

1. Rents

2. Interest

3. Dividends

D. Source of the Income or Deduction of the Individual

1. Income Derived from the Personal Services of the Individual Taxpayer

2. Income Derived by the Taxpayer from the Personal Services of Others

3. Income Derived by the Taxpayer in respect of the Taxpayer's Ownership in an [passthrough] Organization [Principally] Engaged in Providing [a Particular Type] of Services.

4. Deductions or Exclusions Not Available To Service Provider Owning [a Specific Percentage of] and Interest in the Organization.

a. Sole Proprietor

b. Partner in a Partnership.

c. Two-Percent Shareholder in an S Corporation.

V. Policy Considerations in Selecting a Method of Characterizing Compensatory Income

A. Is There a Justification for Distinguishing Compensatory Income from Non-Compensatory Income?

This panel and the article derived from it will not attempt to address the elephant in the room: is there a justification for treating compensatory income distinctly from non-compensatory income. There are various justifications that may be appropriate for certain taxes.[152]

B. Assuming Distinguishing Compensatory Income from Non-Compensatory Income is Justified, Is Having a Single Method of Distinguishing Compensatory from Non-Compensatory Income the Best Policy?

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[152] See, e.g., Graetz, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States (Yale 2008) Chapter VIII, Keep the Wage Tax to Fund Social Insurance.

The absence of a single compelling policy for distinguishing compensatory from non-compensatory income may justify having different rules for different tax items. Nonetheless, for both planning purposes on the part of taxpayers and administrability on the part of the government, a single principle for distinguishing compensatory from non-compensatory income.

C. Assuming Distinguishing Compensatory Income from Non-Compensatory Income and Having a Single Method of Distinguishing Compensatory from Non-Compensatory Income is the Best Policy, What is the Best Method of Distinguishing Compensatory Income from Non-Compensatory Income?

Unfortunately, without an underlying and unifying policy determining which of the alternatives is most beneficial. In the absence of such a policy, rationality may dictate that the most easily administrable policy may be the most desirable, if only because under the current policy, which is neither principled nor rational, in denying penalties on a compensatory income case, it is not surprising that the U.S. Tax Court held:

> Additionally, there were no regulations or administrative or judicial guidance to assist the members at the time: “Limited partner” has never been defined by statute or regulation; Renkemeyer was a case of first impression on the issue, and it was decided in 2011—after the years at issue in this case. Also, the members adopted a fairly conservative (though incorrect) reporting position: They remitted self-employment taxes on the guaranteed payments they received, the amounts of the guaranteed payments were calculated on the basis of a survey of legal salaries in the area, and these guaranteed payment amounts were reasonable on the basis of the survey information. For these reasons the Court concludes that petitioners acted with reasonable cause and in good faith.

Vincent J. Castigliola, et ux., et al., TC Memo 2017-62 (4/12/2017)

D. Questions with Respect to Proposed Legislation

a. **Employment Taxes and Reasonable Compensation: Will the same concept of “reasonable compensation” apply to employment taxes, thereby eliminating the IRC § 1402(a)(13)?**

b. **Reasonable Compensation in Passthroughs: Will the inclusion of reasonable compensation be driven by allocation of income (taxpayer will have reasonable compensation up to the amount of income allocated to the taxpayer), distributions (taxpayer will have reasonable compensation to the extent of distributions, regardless of amount of income allocated to the taxpayer), or other (e.g., taxpayer will be considered to be accumulating an amount that would constitute reasonable compensation but will only have reasonable compensation**

income when there are (a) allocations of income or (b) distributions to the taxpayer.

c. **What is Qualified Business Income: It appears that the special rate (15%) Under H.R. 116 and S. 707 "qualified business income" is defined as:**

all items of income, deduction, loss, or credit properly attributable to the taxpayer from the active conduct of a trade or business in which—

(i) in the case of a partnership, the taxpayer holds a capital or profits interest,

(ii) in the case of an S corporation, the taxpayer is a shareholder,

(iii) in the case of a sole proprietorship or an entity otherwise disregarded as separate from its sole owner, the taxpayer is the sole owner, and

(iv) in the case of a trust or estate, the taxpayer is a beneficiary.

What does *from the **active** conduct of a trade or business* mean? Must the activity be non-passive for the individual taxpayer?

d. **Carried Interest: Will the concept of carried interests be eliminated. If not, when will reasonable compensation be measured?**

e. **Bad Organizations: Will "financial services income" [153] or personal services entities be subject to special rules?[154]**

VI. Conclusion

Notes

<u>Goldilocks:</u> Donald Marron, Goldilocks Meets Private Equity: Taxing Carried Interest Just Right Tax Policy Center, Urban Institute & Brookings Institution October 6, 2016 (Updated October 7, 2016) available at http://www.taxpolicycenter.org/publications/goldilocks-meets-private-equity-taxing-carried-interest-just-right

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[153] H.R. 116 and S. 707 exclude "financial services income (as defined in section 904(d)(2)(D))."

[154] See, e.g., IRC §§ 11(b)(2), 269A, 444(a), 448(b)(2), and 280H (providing special rules for personal service corporations) and Prop. Reg. §1.1402(a)-2(h)(6)(ii) (precluding a partner performing services for a "service partnership" from claiming to be a "limited partner" for self-employment tax purposes).

The Tax Reform Act of 2014: The Tax Reform Act of 2014 [Discussion Draft] February 21, 2014 available at https://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft__022614.pdf

JCT Explanation of The Tax Reform Act of 2014: Joint Committee on Taxation, Technical Explanation, Estimated Revenue Effects, Distributional Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014, a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code (JCS-1-14), September 2014. This document can also be found on our website at www.jct.gov.

2012 CBO Study: Congressional Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax (September 27, 2012) available at https://www.cbo.gov/publication/43644

Mainstreet Fairness Act: Mainstreet Fairness Act, H.R. 116, 115th Cong., 1st Sess. (introduced January 3, 2017)

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Framework: White House, Unified Framework for Fixing Our Broken Tax Code (September 27, 2017) available from a link at https://www.whitehouse.gov/the-press-office/2017/09/27/unified-framework-fixing-our-broken-tax-code.

Blueprint: Republicans Task Force on Tax Reform, A Better Way Our Vision for a Confident America (June 24, 2015) available at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.