July 6, 1999

EXECUTIVE SUMMARY

1. Summary of the recommendation(s).

To amend the Internal Revenue Code of 1986 to provide that income of owners of an entity taxable as a partnership (including a limited liability company) that is attributable to capital is not subject to self-employment tax.

2. Summary of the issue which the recommendation addresses.

Currently, the distributive share of income of a general partner is subject to self-employment tax while the distributive share of income of a limited partner is not subject to self-employment tax, except to the extent that such income represents guaranteed payments for services. It is not clear how members of a limited liability company or their distributive shares of income are treated for these purposes.

3. Explanation of how the proposed policy position will address the issue.

Under the recommendation, Section 1402(a)(13) of the Internal Revenue Code would be amended to provide that income attributable to capital is excluded from "net earnings from self-employment," regardless of whether the taxpayer is a general partner, a limited partner, a member of a limited liability company, or a member of any other entity taxed as a partnership for federal income tax purposes. The proposal includes two safe harbors for measuring income attributable to capital. Also, it grants the Secretary authority to promulgate regulations as necessary to carry out the purposes of these provisions.

Introduction

The American Bar Association Section of Taxation believes that the manner in which the self-employment tax rules apply to members of limited liability companies ("LLCs") and partners of partnerships requires prompt Congressional action. This submission is presented on behalf of the Section of Taxation. Accordingly, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the policy of the Association.

The absence of clear rules in this area impacts a significant number of taxpayers and the government. This need for rules has resulted from both the rapid evolution of state business laws and recent congressional actions summarized below. Faced with the current uncertainty in the law, taxpayers and their advisors are literally "making up" their own guidelines. Both inconsistent and confused reporting positions are being taken. The present lack of guidance encourages noncompliance by taxpayers and precludes uniform enforcement by the IRS.

Background

Section 1401 of the Internal Revenue Code of 1986, as amended, imposes a tax on the "self-employment income" of every individual (the "SECA tax"). Self-employment income is also relevant in determining the amount of contributions that may be made by a partnership or LLC to qualified retirement plans on behalf of its partners or members. Self-employment income is determined by reference to "net earnings from self-employment" in Section 1402. Subject to various exceptions not pertinent to the scope of this proposal, self-employment income generally includes an individual's distributive share" of income or loss of any trade or business conducted by a partnership of which the individual is a member. As a result, a partner's share of partnership income generally is included in self-employment income of the partner.

During the 1970's, various schemes were developed whereby individuals could obtain Social Security benefits by becoming limited partners in partnerships conducting businesses. The limited partners' income from the partnerships would constitute self-employment income without regard to activities of the
individual investor. Under Section 1402 as it then read, that income would be subject to the SECA tax which would count toward the individual's qualification for social security benefits.

Congress viewed those schemes as loopholes and closed them in 1977 by enacting Section 1402(a)(13) to exclude from self-employment income most earnings of an individual attributable to limited partnership interests. The legislative history accompanying the 1977 legislation indicates that Congress intended that, in the case of limited partners, only guaranteed payments for services rendered to the partnership should be treated as net earnings from self employment. H.R. Rep. No. 95-702, 95th Cong., Part 2, at p 40-41 (1977). Under Section 1402(a)(13), a limited partner's distributive share of income is not included in net earnings from self employment, but guaranteed payments for services are.

The business organization forms initially supporting that assumption have changed dramatically. In 1976 and 1985, the Revised Uniform Limited Partnership Act was updated to expand the role limited partners could play in control of a partnership without becoming liable to third parties for debts and obligations of the partnership. Substantially all of the states and the District of Columbia have adopted those changes in their state limited partnership statutes. Consequently, the distinctions that existed in 1977 between general partners and limited partners, in terms of looking to control and/or participation in activities of a partnership to determine whether a limited partner becomes liable to partnership creditors as a general partner, generally have evaporated. As a result of those changes, general and limited partners now differ from one another under state law based primarily on who has apparent authority to bind the partnership with respect to third parties. Generally, only general partners have that power.

Another recent development is the advent of the LLC. Since the enactment of Section 1402(a)(13), all of the states and the District of Columbia have adopted LLC statutes. Generally, LLCs are treated as partnerships for federal tax purposes. There are two principal categories of LLCs: manager-managed and member-managed LLCs. A manager-managed LLC is like a limited partnership in that management and agency authority generally are vested in a manager or managers, and not in all members, of the LLC. A member-managed LLC is like a general partnership in that management and agency authority generally are vested in all the members. Members and managers have significant flexibility to modify their relationships inter se in an LLC operating agreement that functions like a partnership agreement in the partnership context. As with partnerships, the real significance of designation of managers of an LLC is to vest apparent authority to bind in certain persons. Non-manager members of a manager-managed LLC may participate extensively in the activities of the LLC and may provide significant services to the LLC.

The "check-the-box" entity classification regulations also have reduced distinctions among forms of business organizations. Effective January 1, 1997, those regulations have eliminated some rules for classifying partnerships, LLCs and other unincorporated business organizations for federal tax purposes. Businesspeople now may determine whether to be subject to the partnership or the corporate tax regime without having to navigate complex artificial rules in the former regulations. As a result of the check-the-box rules, owners of unincorporated business organizations generally are subject to the same income tax rules regardless of the form of organization selected.

Currently, it is not clear when and whether a member of an LLC qualifies as a "limited partner" for purposes of Section 1402(a)(13). For example, page 2 of the "1997 Instructions for Form 1065 - U.S. Partnership Return of Income," published by the Internal Revenue Service (the "Service"), informs taxpayers that "A limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership. Some members of other entities such as limited liability companies that are classified as partnerships, may be treated as limited partners for certain purposes." The additional discussion in the Instructions at page 19, regarding "Self-Employment/Limited Partners," does not discuss the treatment of members of LLCs.

Regulatory Efforts at Clarification
In an attempt to eliminate the confusion in this area, the Department of Treasury (the "Treasury") first promulgated proposed regulations in 1994. The Section's Task Force on Limited Liability Companies submitted comments on the proposed regulations. In large part, the comments focused on the remaining distinctions between general partners and limited partners in crafting a suggested regulatory solution for identifying those members of an LLC who should be characterized as limited partners for purposes of Section 1402(a)(13) and other sections of the Internal Revenue Code. In response to comments that were received, primarily from tax practitioners, the Treasury in 1997 withdrew the 1994 proposed regulations and proposed new regulations.

The 1997 proposed regulations generated a firestorm of criticism. Although some tax practitioners criticized the new regulations, the most intense critical comments came from non-specialists. It appears that part of that criticism is due to the fact the 1997 proposed regulations would subject to SECA tax limited partners in partnerships formed under state limited partnership acts who are active in the partnership's business. While that result is not necessarily inconsistent with the policy underlying the 1977 legislative change to Section 1402(a), it may or may not have exceeded the Treasury's regulatory authority.

In response to widespread criticism of the 1997 proposed regulations, the Taxpayer Relief Act of 1997 prohibited the Service until July 1, 1998 from issuing or making effective any regulations relating to the definition of a limited partner for SECA tax purposes. Tax practitioners have concluded that, as a result of the congressionally mandated moratorium, "the Internal Revenue Service appears unlikely to reissue the regulations until Congress provides more guidance on the subject." See The BNA Daily Tax Report, July 7, 1998.

**Need for Guidance**

Confusion and uncertainty rule this area of the tax law, and this issue affects a large number of taxpayers. See "The Stealth Moratorium on the Stealth Tax," 81 Tax Notes 868 (Nov. 16, 1998). This confusion and uncertainty encourage noncompliance, have made it difficult for taxpayers to plan transactions and investments, and have made enforcement difficult.

The problem was succinctly summarized in the CCH Standard Federal Tax Report's "Tax Focus," October 15, 1998, where it was noted that "although the limited liability company (LLC) rapidly is becoming the entity of choice for most new closely held business ventures, the self-employment tax treatment of LLC members who are classified as "partners" for federal income tax purposes remains uncertain. Because of this uncertainty, a number of practitioners are still hesitant to recommend using LLCs, opting for the more traditional, corporate form of organization."

The American Institute of Certified Public Accountants ("AICPA") has also recommended an amendment to the Internal Revenue Code to address the SECA tax issue. The AICPA recommendations and the suggestions contained in this report are identical. We agree, for example, that a solution to the problem must focus on whether income is attributable to services versus capital and that only income from rendering services should be subject to the SECA tax. We also agree that a legislative solution would be preferable to a regulatory solution. Further, we agree that where an individual member of a partnership or LLC contributes both capital and services to the enterprise, only income attributable to the services rendered by such member should be subject to the SECA tax, regardless of whether the individual is a general partner or a limited partner (or both) in the partnership and regardless of whether the individual is simply designated as a manager of the LLC.

**Recommendations**

Section 1402(a) operates on the premise that all of an individual partner's income from a partnership that is engaged in a trade or business is self-employment income. For partners in a general partnership (the typical pass-through entity when Section 1402(a) was enacted in 1954), this approach provides administrative simplicity: each general partner simply takes his or her allocable share of partnership
income and reports the full amount (except for interest and dividend income and other specified items) on Form 1040, Schedule SE, for purposes of computing SECA tax. Similarly, each general partner uses the same amount for purposes of computing his or her qualified compensation base for purposes of making contributions to qualified retirement plans. General partners have the flexibility to structure all, a portion, or almost none of their allocable share of partnership income as self-employment income, by owning none, a portion or almost all of their partnership interest as a limited partner (with the remainder as a general partner).

With respect to limited partners, Section 1402(a)(13) excludes from Section 1402(a) all income of a limited partner (except for that income attributable to services for which a guaranteed payment is payable to the limited partner). The tax law does not clearly indicate whether income of a member of an LLC, who is a partner for tax purposes, is ever excluded from SECA tax.

Thus, the result under Section 1402(a) is not always appropriate or, in the case of members of an LLC, apparent. Unfairness would be eliminated by restating Section 1402(a)(13) to exclude from income described in Section 1402(a) that portion of a partner's share of net income attributable to capital.

To implement this proposal, we suggest three changes to Section 1402(a)(13): (i) delete the reference in Section 1402(a)(13) to "limited" partner and make that paragraph applicable to any partner (as such, the rule would apply to any person treated as a partner for tax purposes, including partners of state-law general and limited partnerships and members of LLCs), (ii) specify in Section 1402(a)(13) that income of a partner attributable to capital is excluded from self-employment income and include two safe harbors for measuring such income and (iii) grant Treasury regulatory authority to provide rules as maybe necessary to carry out the purposes of these provisions. Our suggested amendments of Section 1402 (a)(13) are as follows (language to be added is underlined and language to be deleted is struck through):

(a) Net earnings from self-employment.-

The term "net earnings from self employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss B…

(13) (A) there shall be excluded the distributive share of not any item of income or of a limited partner, as such, attributable to capital, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

(B) Safe harbors B For purposes of subparagraph (A), the following amounts shall be treated as income attributable to capital:

(i) the amount, if any, in excess of what would constitute reasonable compensation for services rendered by such partner to the partnership, or

(ii) an amount equal to a reasonable rate of return on unreturned capital of the partner determined as of the beginning of the taxable year.

(C) Definitions. For purposes of subparagraph (B) --

(i) Unreturned Capital. The term "unreturned capital" shall mean the excess of the aggregate amount of money and the fair market value as of the date of contribution of other consideration (net of liabilities) contributed by the partner over the aggregate amount of money and the fair market value as of the date of distribution of other consideration (net of liabilities) distributed by the partnership to the partner.
increased or decreased for the partner's distributive share of all reportable items as determined in section 702. If the partner acquires a partnership interest and the partnership makes an election under section 754, the partner's unreturned capital shall take into account appropriate adjustments under section 743.

(ii) Reasonable rate of return. A reasonable rate of return on unreturned capital shall equal 150 percent (or such higher rate as is established in regulations) of the highest applicable federal rate, as determined under section 1274(d)(1), at the beginning of the partnership's tax year.

(D) The Secretary shall prescribe such regulations as maybe necessary to carry out the purposes of this paragraph:

There are several principles underlying this recommendation that should be incorporated into legislative history. First, income allocable to capital should not be subject to SECA tax (this proposal deals solely with income derived by a person in his or her capacity as a partner in a partnership, although the Section believes the same result should apply in the case of individuals who conduct business as sole proprietors). Second, the aggregate theory should apply so that income of a sole proprietor from an activity that would otherwise be subject to SECA tax would not escape the tax if the activity is transferred to a partnership (and the individual continues to render services to the partnership), and income that would not be subject to tax if earned by an individual should not become subject to the tax because the activity is transferred to a partnership.

Third, current law recognizes that some of the income of a partner may be attributable to capital and other income attributable to services, and the ability to segregate these types of income should be recognized under the changes to Section 1402. Thus, if a partner is allocated income of a partnership in part because of his or her services and in part because of his or her contribution to capital, the portion of income attributable to capital should not be self-employment income. Under current law, the distinction between these types of income is based on the labels "general partner" and "limited partner." The use of these labels may have been appropriate previously, but the distinction should now be based on the source of a partner's income.

Fourth, the source of capital used in the trade or business should not be relevant. Thus, in determining whether income is attributable to capital or services the same conclusion should result if a partner borrows money and contributes the funds to the partnership or if the partnership borrows the money directly. This conclusion is consistent with and analogous to the operation of Section 752, which treats debt incurred by a partnership as a constructive contribution of money by the partners to the partnership.

Finally, legislative history for the proposed change to Section 1402(a)(13) should note that the determination of whether income is attributable to capital is generally made at the partner level. (Section 49(a)(1)(E) includes a provision of current law where the character is determined at the partner level.) Thus, a partner could contribute capital to, and provide no services for, a partnership whose business is a service-oriented business, and this partner would not be subject to the SECA tax on his or her share of partnership income. Similarly, a partner could receive his or her share of partnership income solely as a result of services rendered to a business in which the majority of its income is attributable to capital contributed by other partners, and this partner would be subject to the SECA tax on his or her share of partnership income, unless that income is otherwise excluded from the SECA tax under Section 1402(a).

The characterization of income when a partner both contributes capital and provides services to a partnership raises other questions. The Section of Taxation believes these issues should be addressed by regulation. Certain of the issues are presented in the following situations:

(1) What if income is attributable to property acquired by the partnership with borrowed funds? Ordinarily, as noted above, Section 752 treats debt incurred by the partnership as a constructive contribution of money by the partners to the partnership. Should a similar rule apply under Section
1402(a)(13) so that the partners would be deemed to have received income attributable to capital? If so, should the amount deemed attributable to capital be allocated among all partners in accordance with their proportionate interests in partnership income, their allocable share of liabilities under Section 752, or in some other manner?

(2) Income may be attributable to the contribution of significant capital by a service provider to a service-providing partnership (e.g., a dentist or a doctor). Alternatively, income may be attributable to capital created by services of a partner (e.g., intangibles in a computer software business). Do these facts warrant a different rule or rules?

(3) In certain situations, a partner's income may be attributable to services provided by employees of the partnership (non-partners), regardless of whether the partner has contributed capital. It may be appropriate in these and other situations to consider creating safe harbors or general rules, and these rules may require considering the nature of a partnership's business, although the general rule should still focus on the nature of the partner's individual contributions. Thus, it may be appropriate in certain circumstances to limit the application of the general rule, the safe harbor, or both when a partner has income from a service-oriented business or has income from a capital-oriented business so that such income is characterized for Section 1402 purposes without regard to contributions of capital by the partner. If Congress believes this result may be necessary or appropriate, Congress should make this delegation of regulatory authority explicit in the statute. Our proposal does not give Treasury the authority to conclude that partners may not have the benefit of the statutory safe harbors. Similarly, it may be appropriate to include a general rule when a partner performs a de minimis amount of services for the partnership. The AICPA has suggested that if a partner performs less than 100 hours of services for a partnership during a year, all income of the partner may be deemed to be attributable to capital. This is a reasonable approach in this circumstance, and it would be important to include in legislative history that a 100 hour rule will be included in regulations issued by the Secretary. This conclusion would not require specific regulatory authority."

(4) The safe harbor in our proposed Section 1402(a)(13)(B)(ii) for identifying the minimum amount that may be treated as income attributable to capital is intended as a "simple" safe harbor upon which many taxpayers may rely without undue complexity. Thus, we suggest that regulations should ordinarily permit a partner to treat his or her capital balance as reflected on his or her Schedule K-1 as the amount of his or her "unreturned capital." However, it may be appropriate for regulations to expand upon this safe harbor. For example, regulations may provide that determining a minimum return on capital may depend on the nature of a partnership's business so that in certain circumstances use of a higher percentage of the AFR may be appropriate. Similarly, it may be appropriate in certain circumstances to expand this safe harbor and allow for other adjustments to capital, including for example, upon a revaluation of partnership property when new partners are admitted to a partnership. Further, it would be appropriate to address in regulations the allocation of capital when a partnership has classes of income that are attributable to different activities. For example, a partnership may have income that is attributable to capital used in a trade or business of the partnership and income exempt from SECA income that is attributable to other capital.

(5) While income of a partnership must be attributable to either services or capital, we recognize that the sum of the parts may not always equal the whole, particularly if the law includes one safe harbor based on the value of services and another safe harbor based on the value of capital. For example, assume (i) a partner has contributed $100,000 to and works full-time for an entity treated as a partnership, (ii) reasonable compensation for services is $50,000 and (iii) a reasonable return on the partner's capital is $20,000. If the partner's distributive share of partnership income is $80,000, the partner's earnings subject to self-employment tax would be $50,000 if the reasonable compensation safe harbor is used or $60,000 ($80,000 less $20,000) if the return on capital safe harbor is used. It is anticipated that while both safe
harbors will always be appropriate, in many instances the return on capital safe harbor will be easier to apply.

(6) A similar (and related) issue is the treatment of income of a partnership that is accumulated and reinvested in the business of the partnership. Arguably, income attributable to reinvested earnings should continue to be characterized on the basis that such income is allocated to the partner (i.e., a partner level determination). However, we recognize that a partner who performs services for a partnership could restructure his or her interest if the rule focuses on contributions to the partnership by receiving a distribution of such income and then contributing the amount received in the distribution back to the partnership. Interestingly, a person who is a general partner and a limited partner of a partnership today may already adjust his or her interest in this fashion, and it may not be appropriate to change this result.

(7) Since 1977, partners have been able to determine to a large extent themselves whether income would be excluded from self-employment income. For example, under current law, a person may create a limited partner interest and a general partner interest and then 'manage' the amount of self-employment income by allocating income to the general partner interest or to the limited partner interest (subject to the constraints of Section 704). While the same flexibility may not be necessary if the general rule is changed to exclude from the SECA tax income attributable to capital, some flexibility is still appropriate, given the nature of Section 1402 and the desire to have administrable and fair safe harbors.

(8) Who should make the determinations required by Section 1402(a)(13)? For example, should each partner determine what share of income is attributable to capital and/or his or her reasonable compensation or should either of the determinations be made by the partnership? It is intended under our proposal that the law would allow a partner level determination of amounts of reasonable compensation and selection of the safe harbor basis for determining the amount of income attributable to capital. If a safe harbor is not selected, the partner would determine the amount of income that is attributable to capital.

These issues must be considered further, and it would be appropriate to provide guidance in regulations.

We emphasize that our recommendation would only affect Section 1402(a)(13). Specifically, we do not recommend as part of this report that other exclusions or inclusions in Section 1402 be amended. For example, income from real estate rentals (described in Section 1402(a)(1)) and certain interest and dividends (described in Section 1402(a)(2)) would continue to be excluded from self-employment income, regardless of whether the partner's services helped to generate this income, as such income does not constitute earnings from a trade or business for purposes of Section 1402.

**Other Matters**

Under the check-the-box regulations, a domestic LLC owned by one person is generally disregarded for tax purposes unless the owner elects otherwise. The income of such an LLC is treated for tax purposes as being earned by the single owner. We suggest that the government consider extending our recommended rule to individuals who own 100% of the interests of an LLC and to sole proprietors. Such a rule would result in consistent and fair application of the SECA tax to partners of partnerships, members of LLCs and sole proprietors. Second, Section 211 of the Social Security Act (42 U.S.C. §411(a)(12)) also focuses on income of a limited partner in calculating the earnings that reduce social security benefits. We suggest that the government consider extending our recommended rule to calculating such reductions.

If a legislative solution to the current issues surrounding Section 1402 is not forthcoming or will be delayed for an extended period of time, the best immediately available approach is that adopted in the 1997 proposed regulations. We favor finalization of those regulations, or at least promulgation of temporary regulations, if a legislative solution to these issues is not currently feasible. The treatment of members of LLCs for SECA tax purposes and other purposes which turn on net earnings from self-employment (including a partner's or LLC member's qualified compensation base for purposes of
qualified retirement plan contributions) is a significant issue that begs guidance, and the absence of authority in this area creates a significant problem for both businesspeople and the government.

**Summary**

A variety of state partnership and LLC law developments make the definition of net-earnings from self-employment under Section 1402(a) a critical tax issue for an increasingly large number of businesses and individuals. Unfortunately, the law currently is confusing and its application uncertain. We believe that much of this confusion and uncertainty would be eliminated and the purpose of Section 1402 would be best served if Section 1402(a)(13) were amended to apply to all partners and to provide that only income of a partner attributable to capital is excluded from self-employment income.

We believe these changes and suggestions comport with the trend, exemplified by the check-the-box regulations, to eliminate arcane distinctions in the tax law based on labels whose significance has faded into history.

The Section of Taxation would appreciate the opportunity to work with you and other interested persons in any way possible to resolve the problems faced by members of LLCs and partners in partnerships in determining self-employment income. If legislation is enacted, we intend to assist the Service and Treasury in developing rules and regulations that implement the intent of this proposal.