REPORT #811

TAX SECTION

New York State Bar Association

REPORT ON THE SELF-EMPLOYMENT TAX AS APPLIED TO

OWNERS OF INTERESTS IN PASS-THROUGH ENTITIES

December 9, 1994

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MEMORANDUM

Uniform Self-Employment Tax Treatment of Owners of Interests in Pass-Through Entities

Enclosed is a Report by the New York State Bar Association Tax Section expressing our views concerning the appropriate self-employment tax treatment of owners of interests in pass-through entities. This issue was raised in several of the Health Care bills considered in the recently-ended session of Congress. We hope that any future legislation on this subject will take into account our recommendations.

The Report makes three principal recommendations:

1.The amount of an owner's income subject to self-employment tax should not depend on the nature of the pass-through entity. In other words, while the determination of self-employment income must be based on various factors, it should not be relevant whether the owner is a general partner, limited partner, Scorporation shareholder, owner of an interest in a limited liability company or limited liability partnership, or sole proprietor.

2.No part of an owner's share of income should be treated as self-employment income unless the owner personally performs some minimum threshold level of services. We recommend that the threshold be based on the general standard of “material participation” under Code Section 469 (the passive loss rules).

3. For an owner that does meet the material participation threshold, the self-employment tax rules should recognize that a portion of the owner's income may nevertheless constitute a return on capital rather than compensation for services. Consideration should be given to a variety of methods that might be used in determining the appropriate percentage of the owner's income that is to be treated as self-employment income. While we discuss a number of possibilities, we do not make a particular recommendation in this regard. Any proposed rule must, of course, be evaluated on the basis of fairness, administrability and revenue considerations.

Please let me know if the Tax Section can be of further help on this issue.

Sincerely yours,

Michael L. Schler
Chair, Tax Section

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE SELF-EMPLOYMENT TAX AS APPLIED TO OWNERS OF INTERESTS IN PASS-THROUGH ENTITIES[1]

December 9, 1994

Under the Self-Employment Contributions Act (“SECA”) a federal wage tax is imposed on an individual’s “net earnings from self-employment” (“NESE”). The application of this tax to individuals who own interests in pass-through entities (general partnerships, limited partnerships, limited liability companies and S corporations) can vary dramatically depending on the type of entity involved. The purpose of this report is to identify these differences--which we believe are, for the most part, unwarranted-and to suggest alternatives.

I. CURRENT LAW

Under the Federal Insurance Contributions Act (“FICA”), a wage tax is imposed on employers and employees. For 1994 wages, there is a 6.2% old age, survivors, and disability insurance (“OASDI”) tax and a 1.45 % Medicare hospital insurance (“HI”) tax imposed on boththe employer and the employee. The OASDI tax is imposed on the first $60,600 of wages in 1994; the HI tax applies to all wages without limitation.

[1] The principal authors of this report were Roger J. Baneman and Victor F. Keen. Helpful comments were provided by M. Bernard Aidinoff, Peter v.Z. Cobb, Carolyn Lee, Robert J. Levinsohn, Richard O. Loengard, Jr., Elliot Pisem, Robert Plautz, Laurence Reich, Richard L. Reinhold, Stuart Rosow, Michael L. Schler, Willard B. Taylor and Eugene L. Vogel.

Under SECA, a similar tax is imposed on an individual's NESE. The tax rates, 12.4% for OASDI and 2.9% for HI, are the same as the combined employer and employee rates under FICA, and the OASDI tax is capped at the same level as the OASDI tax under FICA. For Federal income tax purposes, one-half of the SECA tax is deductible.

The NESE of a general partner in a partnership is the partner's distributive share of income or loss from any trade or business of the partnership, excluding certain items of passive income such as interest, dividends and certain real estate rental income. A limited partner's distributive share is not NESE except for guaranteed payments (within the meaning of Section 707(c))[2] to the partner for services rendered to or on behalf of the partnership. An S corporation shareholder's pro rata share of the S corporation's items of income or loss is not NESE; however, wages paid by the S corporation to a shareholder are subject to the employer and employee taxes under FICA. Also, under certain Internal Revenue Service ("IRS") rulings and court cases, if an S corporation shareholder performs services for the S corporation, the shareholder's pro rata share of income may be recharacterized as wages for FICA tax purposes to the extent it is in lieu of reasonable compensation for services. See Rev. Rul. 74-44, 1974-1 C.B. 287;Spicer Accounting Inc. v. U.S., 918 F.2d 90 (9th Cir. 1990); Dunn & Clark P.A. v. U.S. 853 F. Supp. 365 (DC Idaho 1994). Thus, in the case of pass-through entities, theimposition of the wage tax on NESE can vary dramatically based solely on the form of pass-through entity.

[2] All section references are to the Internal Revenue Code of 1986 (the "Code") unless otherwise indicated.

II.CHANGES PROPOSED IN HEALTH CARE BILLS

It was anticipated that the employment tax rules for determining wages (viewing NESE of equity owners of pass-through entities as wages for this purpose) would be used to determine wages for purposes of recent proposed health care legislation. See, e.g., Prepared Statement of Assistant Treasury Secretary (Tax Policy) Leslie B. Samuels before Senate Finance Committee Hearing on Classification of Workers as Employees or Independent Contractors Under Health Care Reform, May 3, 1994 reprinted in Bureau of National Affairs Daily Tax Report No. 84 (5/4/94) at L-5. A number of the health care bills which were introduced in the recently-ended session of Congress but not enacted contained provisions which would have modified the NESE provisions as they apply to pass-through entities.

The Health Security Act. Under the Administration's Health Security Act[3] introduced in November 1993, NESE included an S corporation shareholder's pro rata share of income or loss under certain circumstances and the definition of NESE was expanded for limited partners.

Under the S corporation provision, if a "2-percent shareholder" of the S corporation "materially participated" in the activities of the S corporation during a taxable year, NESE would have included the shareholder's pro rata share of taxable income or loss from any "service-related business" carried on by the S corporation. A "2-percent shareholder" was anyshareholder owning more than 2 % of the S corporation stock at any time during the taxable year. A "service-related business" was any trade or business involving the performance of services in the

[3] H.R. 3600, S. 1757 and 1775

fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees. The exclusion provided to general partners under current law for certain passive income of partnerships would also have applied to shareholders of S corporations.

As for limited partners, the Health Security Act provided that a limited partner’s distributive share of income or loss would have been excluded from NESE only if the limited partner did not “materially participate” in the partnership’s activities.

<u>Senate Finance Committee Bill</u>. In July 1994, the Senate Finance Committee reported its version of the Health Security Act. The Senate Finance Committee Bill included the following modifications of the NESE provisions in the Health Security Act:

1. An S corporation shareholder’s pro rata share and a limited partner’s distributive share of the relevant income or loss would constitute NESE only if the shareholder or limited partner “provide[d] significant services to or on behalf of the entity rather than “materially participate[d] in the activities of” the entity, as provided in the Health Security Act.

2. Only 80% of an S corporation shareholders’ pro rata share or a limited partner’s distributive share of the relevant income or loss would be treated as NESE, rather than 100%, as provided in the Health Security Act. Unlike the Health Security Act, only a limited partnership’s income from service-related businesses would be taken into account in determining a limited partner’s NESE.

3. The definition of "service-related business" would be narrowed. "Service-related business" would exclude, in the field of health, services with respect to in-patient personal care facilities and, in the field of financial services, lending or brokerage services. In addition, the residual definition of "service-related business" would "or any trade or business where the Secretary of the Treasury determines that capital is an insignificant income-producing factor for the trade or business" rather than "or any trade or business where the principal asset is the reputation or skill of one or more of its employees".

4. A taxpayer's NESE would generally be reduced by 40% of the lesser of (i) the taxpayer's allocable share of inventory income, or (ii) the amount by which the taxpayer's NESE for the taxable year exceeded $135,000. For a dealer in securities (as defined in Section 475), inventory income would generally include interest, dividends and other income with respect to securities held as a dealer. There was no comparable provision in the Health Security Act.

The Mitchell Bill. In August 1994, Senator George Mitchell introduced a bill[4] as a substitute for the Senate Finance Committee Bill. The Mitchell Bill contained a new provision relating to NESE of S corporation shareholders and limited partners. Under this new provision:

1. If an S corporation shareholder were a "2-percent shareholder" and provided significant services to or on behalf of the S corporation, then, in general, such shareholder's NESE would include his or her pro rata share of the taxable income or

[4] S.2357

loss from the active conduct of trades or businesses by the corporation. However, the amount includable as NESE for any taxable year under this provision was limited to the lesser of (a) 30% of the Social Security “contribution and benefit base”, or (b) the excess of such contribution and benefit baseover the sum of the taxpayer’s NESE for the taxable year without regard to this provision and the taxpayer’s wages for the taxable year. For 1994, the contribution and benefit base is $60,600 and thus the limitation would be $18,180.

2. If a limited partner provided significant services to or on behalf of the partnership, then, in general, his or her distributive share of the partnership’s taxable income or loss from the partnership’s active conduct of trades or businesses would be included as NESE, subject to the same limitation as is applicable to S corporation shareholders.

3. There was a partial exclusion for certain inventory income as in the Senate Finance Committee Bill.

IV.RECOMMENDATIONS

We have three recommendations:

1. The NESE provisions should be substantially identical for general partners, limitedpartners, limited liability company (“LLC”) members, limited liability partnership (“LLP”) members, S corporation shareholders and sole proprietors. A comprehensive revision of the NESE provisions applicable to pass-through entities, taking into account recommendations 2.and 3.below, should apply to general partners, limited partners, S

corporationshareholders, LLC and LLP members and sole proprietors.[5]

2. There should be a threshold for classifying an equity owner's pro rata share of income or loss from a pass-through entity as NESE based upon the quantum of services provided by the equity owner. We believe that this threshold should be "material participation" (within the meaning of Section 469) by the equity owner in the activities of the entity.

3. The NESE provisions applicable to pass-through entities should take account of the possibility that, even for an equity owner who materially participates, a portion of such equity owner's pro rata share of the pass-through entity's taxable income or loss may constitute a return on capital rather than compensation for services properly classified as NESE. The Senate Finance Committee Bill took account of this possibility by including 80%, rather than 100%, of a significant service-providing equity owner's pro rata share of the pass-through entity's taxable income or loss. We believe that other possibilities should be considered, including (i) providing different percentages of inclusion for different categories of businesses which differ as to degree of service intensiveness; (ii) allowing the equity owner to prove the extent to which his or her pro rata share of income or loss is a return on capital as distinguished from compensation for services, with a safe harbor deemed return on contributed capital; and (iii) treating anequity

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5 In the balance of this report, we will occasionally refer generically (i) to an S corporation, a general or limited partnership or a LLC or LLP as a "pass-through entity"; (ii) to an S corporation shareholder, general or limited partner or LLC or LLP member as an "equity owner"; and (iii) to an S corporation shareholder's pro rata share of income or loss or a partner's or LLC or LLP member's distributive share of income or loss as a "pro rata share".

owner’s pro rata share of the entity’s income from capital as not constituting NESE.

V.DISCUSSION OF RECOMMENDATIONS

We are sympathetic to the objective reflected in the proposed changes of precluding S corporation shareholders and partners from avoiding employment taxes by taking theircompensation in the form of pro rata shares or distributive shares. However, as discussed below, we believe that (1) the rules should be uniform for equity owners in the different pass-through entities; (2) no portion of an equity owner’s share of income from a pass-through entity should be treated as NESE unless the equity owner materially participates in the pass-through entity’s activities; and (3) the rules should take account of the distinction between compensation for services and returns on contributed capital The “uncapping” of the HI tax (Le. the elimination of the $135,000 cap on wages and NESE subject to this tax) starting in 1994 causes these rules to possess a greater significance than prior years.

1. Uniform provision for general partners, limited partners, LLC and LLP members and S corporation shareholders. The SECA tax is a tax on the earnings from services, as distinguished from earnings on capital. A general partner, limited partner or S corporation shareholder may each have a distributive share or pro rata share of the partnership’s or S corporation’s profits which represents compensation for the equity owner’s services and which therefore should be classified as NESE. In each case, unlike the case of a C corporation, the equity owner may have a tax incentive to take his or her compensation in the form of a distributive share or pro rata share instead of salary and, therefore, the classification of the equity owner’s share as NESE

may be appropriate. On the other hand, in each case, the equity owner's distributive share or pro rata share may represent a return on capital, in which event such return should not be NESE.

The law, as it would have been revised by the Health Security Act and the Senate Finance Committee Bill, would essentially have continued the irrebuttable presumption that a general partner's distributive share is 100% NESE (except for that portion attributable to certainpassive income and, in the case of the Finance Committee Bill, certain inventory income). While it may be true as a general matter that general partners are more likely to perform services than limited partners and, to a lesser extent, than S corporation shareholders, this is not always true. To the extent that a general partner does not perform significant services, the general partner's distributive share should not be NESE under circumstances where a limited partner or S corporation shareholder would not have NESE. Similarly, there is no reason why the NESE standards for S corporation shareholders should differ from those for limited partners, since both can perform services for the entity as employees or independent contractors. See, e.g., Delaware Code Annotated Title 6, Section 17-303(1) (1993). In this regard, we note that, in a significant improvement over the Health Security Act, the Senate Finance Committee Bill provided largely (but not entirely) identical provisions for S corporation shareholders and limited partners. One difference in the treatment of S corporation shareholders and limited partners in the Senate Finance Committee Bill is that the provisions of that Bill would have applied to all limited partners, regardless of their percentage interest, but would have applied only to "2-percent shareholders" of S corporations. The 2-percent shareholder limitation was presumably intended to be consistent with Section 1372, which treats 2-percent shareholders in the same manner as partners for employee fringe benefit purposes. Although a sensible case can be made for consistency with Section 1372, on balance we would recommend eliminating the 2-percent shareholder limitation in the NESE context to provide consistency with other pass-through entities.

The expected widespread emergence of LLCs and LLPs underlines the importance of uniform NESE standards. An LLC or LLP is generally treated as a partnership for Federalincome tax purposes but its members may combine attributes of general partners (power to manage or operate the business) and limited partners (limited liability). In the absence of uniform NESE standards applicable to all pass-through entities, there would have to be a determination whether the general partner or limited partner standards apply to members of LLCs and LLPs, either on a uniform or case-by-case basis. This determination would often be difficult; for this reason alone a single standard applicable to all pass-through entities seems essential. Finally, we see no reason why the same NESE standards should not apply to sole proprietors as well.

Accordingly, an administrable test should be devised to distinguish between pass-through earnings that are NESE and those that are not NESE, and the same test should apply to general partners, limited partners, LLC and LLP members, S corporation shareholders and sole proprietors.[6]

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[6] We recognize that the extension of such uniform standards to general partners and sole proprietors may have a negative revenue impact. However, the extension of the NESE provisions to equity owners who provide services to pass-through entities where capital is material (discussed below) would presumably have a positive revenue effect. We believe that consistency among the various pass-through entities (and sole proprietors) is an important goal, and, while we are not revenue estimators, we would hope that such consistency could be achieved consistent with revenue neutrality.

2. Threshold Test for NESE Inclusion. Both the Senate Finance Committee Bill and the Health Security Act adopted the concept that no part of an equity owner's share of income from a pass-through entity should be treated as NESE unless such owner provided some minimum amount of services. We agree that such a threshold test is appropriate.

As to what the threshold test should be, the Health Security Act provided that an S corporation shareholder must "materially participate" in the activities of an S corporation as aprerequisite for the shareholder's inclusion as NESE of his or her pro rata share of the taxable income or loss of the S corporation's service-related businesses. Similarly, under the Health Security Act, a limited partner must "materially participate" in the partnership's activities as a prerequisite for the limited partner's inclusion as NESE of his or her distributive share of the partnership's taxable income or loss. The Senate Finance Committee Bill substituted a "provides substantial services" threshold for the "material participation" threshold.

The Health Security Act did not define "material participation". In the context of the passive activity loss provisions of Section 469, an individual other than a limited partner is generally treated under the Regulations as materially participating in an activity for a taxable year if:

1. Theindividual participates in the activity for more than 500 hours during the year.

2. Theindividual's participation in the activity constitutes substantially all of theparticipation in the activity of all individuals (including non-owners) for the year:

3. The individual participates in the activity for more than 100 hours during the year and the individual’s participation is not less than the participation of any other individual (including non-owners) for the year;

4. Theactivity is a “significant participation activity” (generally, the individualspends more than 100 hours but less than 500 hours) and the individual’s aggregate participation in all significant participation activities exceeds 500 hours for the year;

5. Theindividual materially participated for any 5 years during the immediatelypreceding 10 years;

6. The activity is a personal service activity (health, law, engineering, etc. or any other trade or business where capital is not a material income-producing factor) and the individual materially participated for any 3 taxable years (whether or not consecutive) preceding the current year; or

7 Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous and substantial basis during the year.
Temp. Treas. Reg. 1.469-5T(a).

A limited partner is considered as materially participating in an activity if the standards of paragraphs 1, 5 or 6 are satisfied. Temp. Treas. Reg. 1.469-5T(e)(2).

Under Section 1402(a)(1), rent paid to an owner or tenant who shares in the agricultural or horticultural production from the land is not treated as NESE unless the owner or tenant materially participates in the production or management of production of the commodity produced. Material participation for this purpose is described in Treas. Reg. Section 1.1402(a)-4(b)(4) and the examples in Treas. Reg. Section 1.1402(a)-4(b)(6). See also Hyde v. Comm’r, 64 TCM 265 (1992); Mangels v. U.S., 828 F.2d 1324 (8th Cir. 1987); Estate of Coon v. Comm’r, 81 T.C. 602 (1983); Rev. Rul. 64-32, 1964-1 C.B. 319; Rev. Rul. 57-58, 1957-1 C.B. 270.

The Joint Committee explanation of the Health Security Act refers to the “material participation” standard in Section 469 and Section 1402(a)(1), but declines to specify which, if either, of these different meanings is intended to apply for purposes of the NESE provisions for S corporation shareholders and limited partners. See Joint Committee on Taxation, Descriptionand Analysis of H.R. 3600, S. 1757 and S. 1775 (“Health Security Act”) (JCS-20-93), December 20, 1993 at 39-40.

We believe that the general Section 469 definition of material participation should be the threshold for an equity owner’s inclusion of NESE from a pass-through entity, i.e., that an equity owner must materially participate in the activities of the pass-through entity as a prerequisite for the equity owner’s inclusion as NESE of all or a portion of his or her pro rata share from the pass-through entity. First, the objective of the passive loss rules is generally to distinguish active participants from passive investors, which is similar to the goal in the NESE context of distinguishing equity owners deriving compensation from services from equity owners deriving returns on capital. Second, the Section 469 definition of material participation would appear to produce relatively sensible results in the NESE context. Third, use of the existing Section 469 material participation rules would eliminate the necessity of developing a new test for use in the NESE context; a large amount of effort has gone into the development and taxpayer understanding of the Section 469 rules, and it would be an unreasonable burden on Treasury, the IRS and taxpayers to require another comprehensive set of rules to be developed, understood and enforced.

In summary, although the fit of the Section 469 material participation rules in the NESE context is not perfect, we believe that the advantage of incorporating existing law outweighs the disadvantage of not having a rule specifically crafted for the NESE provisions.

Moreover, in keeping with our recommendation for consistency in treatment of all owners of pass-through entities, we do not believe that the special rule for limited partners in the Section 469 regulations should be carried over to the NESE, context. Rather, we believe the materialparticipation threshold should be the more general standard under those regulations regardless of whether the individual is a general partner, limited partner, member of an LLC or LLP. or sole proprietor. We believe the more general standard is the appropriate standard for NESE purposes in all of these cases.

3. Treating Portion of Pro Rata Share as Return on Capital Rather than as NESE. As a theoretical tax policy matter, the determination of whether an equity owner's pro rata share of a pass-through entity's taxable income or loss is NESE should be made at the equity owner level. To the extent that the pro rata share is compensation for the equity owner's services, the pro rata share should be NESE. To the extent that the pro rata share represents a return on the equity owner's capital, the pro rata share should not be NESE. The business or activity of the pass-through entity should be irrelevant to the determination.

There are at least two ways of determining in theory what portion of the equity owner’s pro rata share represents compensation for the equity owner’s services. First, an arm’s length salary equivalent could be viewed as the proper measure of the portion of the equity owner’s pro rata share constituting compensation for the equity owner’s services. The balance would be viewed either as a return on capital or as an “enterprise profit” constituting neither compensation for services nor return on capital.[7] Alternatively, one could determine an arm’s length returnon the equity owner’s capital and treat the balance as compensation for the equity owner’s services. This would have the effect of treating the equity owner’s pro rata share of the “enterprise profit” as compensation for services constituting NESE.

In the interest of providing an administrable standard, the Senate Finance Committee Bill departed from a theoretically pure approach. The Senate Finance Committee Bill based its NESE determination on a combination of the equity owner’s activities and the pass-through entity’s activities.[8] If the equity owner provided significant services to or on behalf of the pass- though entity and the pass-through entity carried on a service-related business, then 80% of the equity owner’s pro rata share of

[7] As an example of “enterprise profit”, consider a partnership started by two individuals to provide a new kind of delivery service. Assume that the partners do not put up any capital, the partners are passive investors after creating the idea for the business, and that the partnership hires employees to manage the business and perform the services. The partners’ share of profit is attributable neither to their capital (unless their idea is viewed as capital) nor to their services and thus might be viewed as “enterprise profit”. Similarly, profit derived from services of associates in law firms might also be considered “enterprise profit” since it is attributable to neither partner services nor partner capital.

[8] In the context of the Senate Finance Committee Bill, “pass-through entity” refers only to an S corporation or a limited partnership and “equity owner” refers only to an S corporation shareholder or a limited partner.

taxable income or loss from the service-related business was classified as NESE. In effect, the Senate Finance Committee Bill created a conclusive presumption that if the pass-through entity’s business is service-intensive, then 80% of the pro rata shares of ail significant service providers would be treated as NESE.

The Senate Finance Committee Bill’s approach is both underinclusive and overinclusive in certain respects. Consider, for example, the case where an S corporation is engaged in a manufacturing business and a particular shareholder performs services for (and contributes no capital to) the business. If the shareholder receives no other compensation from the corporation, from a tax policy viewpoint the shareholder’s pro rata share of the S corporation’s taxable income or loss could appropriately be treated as NESE on the basis that his or her pro rata sharerepresents compensation for services.[9] However, under the Senate Finance Committee Bill, the shareholder’s pro rata share is not treated as NESE because the S corporation is not engaged in a service-related business. In this respect, the Senate Finance Committee’s approach is underinclusive.

Consider alternatively the case where an S corporation shareholder performs significant services for an S corporation engaged in a service-related business. Under the Senate Finance Committee approach, 80% of the shareholder’s pro rata share of the corporation’s income or loss will be treated as NESE. If, in fact, the shareholder contributes no capital, this will

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[9] We assume that the shareholder’s receipt of stock was not itself considered to be compensation for services. To the extent it was, the compensation income on the receipt of the stock would itself be NESE, and taxable income or loss with respect to the stock would not be NESE because the shareholder’s ongoing services would already have been compensated and the income allocation should not again be compensation for the same services.

understate by as much as 20 % the shareholder’s theoretically correct NESE. On the other hand, if the shareholder contributes significant capital, the shareholder is deprived of the opportunity to prove that less than 80% of his or her pro rata share of the corporation’s taxable income or loss should be NESE. Thus, for S corporations engaged in a service-related business, the Senate Finance Committee’s approach may be underinclusive or overinclusive.

Despite these tax policy weaknesses, the approach of the Senate Finance Committee Bill has administrative advantages. The 80% test is relatively simple to apply for both the government and taxpayers. Establishing what portion of an equity owner’s return is attributable to capital can be difficult in practice. The law under Section 911 (determining an individual’s foreign earned income qualifying for exclusion) and under former Section 1348 (determining an individual’s personal service income qualifying for a lower tax rate) suggests the difficulty ofthis task. We believe the overall approach of the Senate Finance Committee Bill of including less than 100% of an equity owner’s pro rata share as NESE if the equity owner performs significant services for the pass-through entity is a reasonable attempt to balance tax policy theory and administrative concerns.

However, even embracing the Senate Finance Committee’s overall approach, there is a range of alternatives that should be considered. Pass-through entities might be viewed as falling within three categories: (i) those engaged in specified activities that are particularly service-intensive and use particularly little capital, such as the Senate Finance Committee’s specified categories of health (other than with respect to in-patient personal care facilities), law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics or financial services (other than lending or brokerage services): (ii) those engaged in activities not specified in (i) but in which capital <u>is not</u> a material income-producing factor; and (iii) those engaged in activities not specified in (i) in which capital is a material income-producing factor (e.g., a manufacturing business). The following table illustrates some of the possible options, assuming in each case that an equity owner satisfies the material participation requirement:

OPTION	HEALTH, LAW, ENGINEERING ETC.	OTHER SERVICES: CAPITAL NOT MATERIAL	OTHER SERVICES: CAPITAL MATERIAL
1	100%	80%	80%
2	100%	80%	0
3	80%	80%	80%
4	80%	80%	0

* Percentages represent percentage of e» ity owner's share of trade or business income from pass-through entity treated as NESE.

Obviously, the table illustrates only a few of the possibilities. Alternatives along these lines must be evaluated on the basis of fairness, administrability and revenue considerations.

For example, Options 1 and 2 embody the notion that certain businesses are so service-intensive that all equity owners who provide significant services should have their entire pro rata shares of income or loss treated as NESE. We recognize the merit of this notion. Options 1 and 3 reflect the notion that, even in a business where capital is a material income-producing factor (e.g., a manufacturing business), equity owners who are significant service-providers should have most of their pro rata shares of income or loss treated as NESE. Options 2 and 4 reflect the notion that if capital is a material income-producing factor, even an equity owner that materially participates in the activity should not have NESE, presumably because of theimpossibility of determining a fair uniform allocation of income between NESE and non-NESE income for allsuch persons. Option 4 is the approach of the Senate Finance Committee Bill.[10]

An alternative approach would be to permit equity owners to prove that some portion of their pro rata share was a return on capital[11] not constituting NESE, combined with a safe harbor. A safe harbor might provide that an equity owner could treat as a return on capital (and therefore not NESE) an amount equal to the equity owner's net cumulative capital contributions (measured, e.g., by original contributions or tax basis[12]) multiplied by the applicable federal rate plus some margin {e.g., two percentage points). This would provide a more accurate measure of the portion of an equity owner's pro rata share of income or loss constituting NESE, although at a cost of somewhat more administrative complexity. The safe harbor would, of course, be in lieu of any specific exclusion for interest or other investment income of the entity.

Finally, one might provide that an equity owner's pro rata share of income which, at the pass-through entity level, is

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[10] By setting forth this chart of alternatives, we are merely illustrating the possiblealternatives. In particular, we are not advocating the position that the proper NESE percentage for activities described in the first column of the chart should be 80% rather than 100%.

[11] For this purpose, any goodwill, client base or going concern value of a professionalservice practice should not be considered capital.

[12] The use of tax basis in this context would require adjustments and would pose various issues. For example, the equity owner's share of the entity's debt would presumably be subtracted from his or her tax basis in the pass-through entity. In the case of transferees of equity owner interests, it would seem that the share of inside basis rather than outside basis should be utilized. Whether inside or outside basis is used, however, any approach based on tax basis will create artificial distinctions between new or newly purchased enterprises (with relatively high tax bases) and established and long-held enterprises (which are likely to have lower tax bases because of depreciation deductions).

derived from capital should be excluded from NESE.[13] Althoughthis would be a departure from the tax policy theory that the determination should be made at the equity owner level, it would in a rough way serve to exclude from an equity owner's NESE income that is capital-generated (although not necessarily from the particular equity owner's capital). Two of the changes in the Senate Finance Committee Bill embodied this approach. First, the Bill excluded from the definition of service-related businesses services from in-patient personal care facilities and lending or brokerage services. These may be viewed as businesses where capital is likely to be an important income-producing factor and therefore as a way of excluding from NESE a class of income that is likely to have a relatively large component of income from capital. Second, the Bill excluded from NESE a certain percentage of an individual's share of income from inventory. This may be viewed as an approximate way of excluding income attributable to capital because inventory income in part reflects a return on the capital used to purchase the inventory.

However, we note that these special provisions in the Senate Finance Committee Bill addressed only a very narrow category of income generated from capital. It would be fairer to expand these categories to a more general class of income from capital.

The Mitchell Bill. We also have some specific comments on the NESE provisions contained in the Mitchell Bill. We disagree with the approach of the Mitchell Bill relating to NESE of S corporation shareholders and limited partners for the following reasons:

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[13] This approach or the approach described in the preceding paragraphcould alsobecombined with certain of the options illustrated in the table.

1. It is difficult to justify, as a tax policy matter, a maximum NESE inclusion as low as 30% of the contribution and benefit base (currently, a limitation of $18,160). It would seem that for a significant service provider, particularly in a service-intensive business, a larger portion of his or her pro rata share of taxable income or loss (up to 100%) would in almost allcases constitute compensation for services. For example, if a law firm is organized as an S corporation, there seems to be no policy justification for limiting the shareholders' NESE to $18,160.

2. It is not clear under the Mitchell Bill whether the IRS would be precluded from arguing that an additional portion of an equity owner's pro rata share should be treated as wages, therefore subjecting both the employer and employee to employment taxes on such deemed wages. For example, suppose that an individual accountant is the sole shareholder of an S corporation which conducts an accounting business. Suppose further that his 100% share of the S corporation's income, all of which derives from his performance of accounting services, is $200,000. Under the Mitchell Bill, $18,160 of his share is treated as NESE. It is not clear whether the Service could assert that, in addition, some or all of his remaining share should be treated as wages to him and therefore subject to employee and employer OASDI and HI taxes. We believe that an important goal of the legislation should be to provide a statutory substitute for this type of ad hoc challenge by the IRS.

3. Finally, we believe that the use of such a low limitation for S corporation shareholders and limited partners would, as a policy and revenue matter, effectively preclude the possibility of a uniform standard applying to general partners, limited partners, S corporation shareholders and LLC and LLP

members. We believe that this type of uniformity is an important goal and should not be discarded. Moreover, the approach of the Mitchell Bill would create an employment tax incentive for all service-providers to use S corporations or limited partnerships and we do not think it desirable to create these kinds of incentives. The operativeconsideration should be the equity owner’s performance of services, not the form of pass-through entity.

Terminated or retired owners. We have not addressed in this report the appropriate NESE treatment of a terminated or retired equity owner’s nonqualified retirement payments (including a share of income of the pass-through entity). Payments of this type to a retired owner might be considered generally to represent deferred payments for services or for the use of capital, and thus it might be thought that these payments in general should have the same NESE or non-NESE character as pre-retirement payments. Our proposed “material participation” test would achieve this result to some extent, since, as described above, an individual can be treated as materially participating in an activity in the current year based on his or her participation in past years. However, we note that Section 1402(a)(10) excludes from NESE most retirement payments made to a partner who renders no services to the partnership during the taxable year. If the policy behind this provision is to be continued, a similar exception would have to be made to the definition of “material participation”. In any event, we believe that a uniform rule should be adopted for post-retirement payments to owners of all pass-through entities.