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Re: JCT Proposal on SECA Taxation

Dear Mr. Yin and Ms. Matthews:

We are pleased to submit the New York State Bar Association Tax Section's Report No. 1097 (the "Report") commenting on the Joint Committee on Taxation's January 2005 proposal to enact legislation addressing the self-employment taxation of members of pass-through entities (the "JCT Proposal"). As you may recall, you requested our comments on this subject at our meeting earlier this year. The Report is the fourth in a series of reports of the Tax Section on this general topic.

Section 1402 of the Code imposes self-employment tax ("SECA") on a general partner's share of partnership income, with some exceptions. Limited partners, by contrast, are subject to SECA only on guaranteed payments for services. These provisions do not address, by their terms, the taxation of members of LLCs. The absence of a rule applicable to

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members of LLCs has created uncertainty, and some LLC members may be taking the position that they are not subject to SECA taxes.

Our Report strongly endorses the JCT's attempt to deal with this and related issues through legislation rather than through regulation. Prior attempts to rationalize the SECA taxation of members of pass-through entities have been mainly regulatory, but none have resulted in final regulations. Because the problems sought to be addressed by the JCT Proposal are legislative in origin, they are difficult to address by regulations and are best addressed by amending legislation.

The JCT Proposal would impose SECA tax on all owners of pass-through entities, including S corporation shareholders who are currently subject only to FICA on reasonable compensation. The JCT Proposal would, however, measure the base of the tax by reference to distributive share income only for owners of pass-through entities who materially participate in the entity's business. Other owners would be subject to SECA only on reasonable compensation.

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

Once the appropriate universe of persons subject to tax on distributive share income has been identified by application of the material participation test, we believe, and have consistently advocated, that the tax base should be narrowed in order to bifurcate income from labor and income from capital. The JCT Proposal considered but rejected such a narrowing. For the reasons described in the Report, we believe that the JCT Proposal goes too far in the direction of extending self-employment taxes to income from capital, as opposed to income from labor, thereby widening the gap in treatment between otherwise similarly-situated employees and self-employed persons.

We also disagree with the portion of the JCT Proposal that would repeal the current Section 1402 exclusions for items of generally passive income (such as dividends and interest) in the case of enumerated types of service partnerships. These exclusions have been part of settled law for many years, and we do not see any reason why they should be changed.

We support the JCT Proposal's extension to shareholders of S corporations of the same rules applicable to owners of other pass-through entities. However, our Report points out some practical difficulties that may be entailed in so doing. We are uncertain whether the JCT Proposal is intended to treat such shareholders as self-employed for all purposes of the Code, or only for purposes of SECA.

We appreciate your consideration of our recommendations and comments. Please feel free to contact us if you have any questions regarding the Report. As always, we would be happy to discuss them with you.

Respectfully submitted,



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