NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

LEGISLATIVE PROPOSAL REGARDING EMPLOYMENT TAXES AND PROFESSIONAL SERVICE BUSINESSES

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

LEGISLATIVE PROPOSAL REGARDING EMPLOYMENT TAXES AND PROFESSIONAL SERVICE BUSINESSES[1]

This report of the New York State Bar Association Tax Section (the "Report") provides comments on the recent legislative proposal addressing the employment tax treatment of individuals engaged in professional services businesses (referred to herein as the "Proposal"), introduced in Section 413 of the original version of H.R. 4213 "The American Jobs and Closing Tax Loopholes Act" (the "House Bill"). The Proposal was not included in the final version of HR 4213 passed by Congress this past July.

Generally speaking, the Proposal would require partners of partnerships[2] and certain shareholders of S corporations who, in each case, provide substantial services with respect to a professional service business conducted by the entity, to take into account for purposes of determining net earnings from self employment ("NESE") their distributive share of income that is attributable to the business. Certain items of income that are currently excluded from NESE (dividends, interest, certain rental income and capital gains) would retain their character as such and would not be subject to SECA tax.

We commend Congress for introducing a legislative measure that, if enacted, would serve to conform the payroll and self-employment tax treatment of S corporation, partnership, and limited liability company employee-members engaged in service businesses. We endorse efforts to reduce opportunities

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[1] The principal drafter of this report was Elizabeth Kessenides, with substantial contributions from Peter Blessing, Andrew Bloom and Jesse Jacobsen. Helpful comments were received from Kim Blanchard, Stephen Land, Willard Taylor, Vadim Mahmoudov, Michael Schler, James Brown, Antar Jones and David Miller.

[2] "Partner" and "partnership", when used in this Report, refer to the meaning of these terms for federal income tax purposes. Thus, the term "partnership" refers to any entity classified as a partnership for tax purposes (including a limited liability company), and a "partner" includes a member of a tax partnership (whether a general partnership, limited partnership, or limited liability company).

to take advantage of what has become, in practice, a significant tax loophole. This report comments on certain technical aspects of the Proposal included in the House Bill. Our recommendations address aspects of the Proposal that might be revised in order to better reflect the intended scope of the proposed legislation and to reduce uncertainty in its application. We also provide comments on aspects of the legislative text which, as currently drafted, appear to reach certain unintended results. We hope these comments, if incorporated into the text of any similar legislation, will aid in achieving the intended purpose of the legislation and allow for increased fairness in its application.

In making these comments, we have accepted the intended goal of the Proposal as being one that targets a defined category of non-capital intensive service businesses. Some previous attempts to address the employment tax gap would have applied more broadly to all S corporations, partnerships, and limited liability companies regardless of the nature of their business activity. We believe that the application of payroll taxes[3] to flow-through entities will eventually need to be addressed more broadly, beyond the category of professional service businesses. At the same time, a targeted proposal aimed at non-capital intensive businesses has merit, as it largely eliminates the need to separate "income for labor" from "income for capital" while at the same time addressing a significant aspect of the issues in this area. A staggered approach to dealing with the payroll tax uncertainties and gaps could be adopted. We view the House Bill measure as a worthy one and, if enacted, it may serve to provide experiential information and a framework for future legislation addressing the subject of employment/payroll taxes more broadly.

Our report is divided into four parts:

1. A summary of our recommendations.
2. A general discussion of the Proposal, including current law as it applies to S Corporations and partnerships.

[3] References herein to "payroll taxes" are intended to refer to Social Security and Medicare taxes imposed on wages under the Federal Insurance Contribution Act and on net earnings from self-employment imposed under the Self Employment Contributions Act.

3. A discussion of our recommendations.
4. An appendix summarizing certain previous proposals in relation to self employment taxes and flow-through entities.

I. Summary of Recommendations

A. Definition of Disqualified S Corporation.

The Proposal applies, in general, to the partners of a Partnership and shareholders of an S corporation performing substantial services if the entity is engaged in a "professional service business" ("PSB"), defined in proposed Section 1402(m)(3) 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." The enumerated list of professional service businesses references a limited category of businesses that are generally understood to be dependent upon the skill and reputation of their employees, where capital is not a material income-producing factor.

With respect to S corporations, however, Proposed Section 1402(m)(1)(C) imposes a second filter: the proposed statutory provision would apply only to a defined subset of S corporations, "disqualified S corporations" ("DSC"s) . A DSC is defined, in one case, to include an S corporation engaged in a PSB where "the principal asset of such business is the reputation or skill of three or fewer employees." We recommend that the reference to a "principal asset" be eliminated. We believe that a "principal asset" test raises questions as to the need to value the company's assets, such as goodwill (something we do not believe is necessary, or intended, in order to achieve the purposes of the proposed legislation). In addition, we believe that the reference to the skill or reputation of "three or fewer" employees imposes an entirely arbitrary cutoff and should be eliminated. We recommend that an S corporation engaged in a PSB be covered by the provisions in Section 1402(m), regardless of whether the business depends on the skill or reputation of any particular number of employees.

A DSC is also defined to include an S corporation that is a partner in a partnership engaged in a PSB *if* "substantially all" of the S corporation's activities are performed in connection with the partnership. We recommend that the "substantially all" standard be eliminated. In essence, we recommend that where an S corporation holds an interest in a partnership engaged in a professional service business, the S corporation fall within the definition of DSC. Thus, we believe that the applicable provisions of Section 1402(m)(1)(A) should be applied to treat as NESE any distributive share of income attributable to the share of income flowing from a partnership engaged in a PSB, that is earned indirectly through an S corporation.

B. Meaning of Substantial Services.

Proposed Section 1402(m) would apply to shareholders of S corporations and partners who provide "substantial services". We recommend that the proper measure of whether shareholders or partners should be required to treat their distributive share as NESE should turn upon a "material participation" standard that is essentially the same as the test that applies in the passive activity loss rules contained in the Section 469 regulations. Thus, we recommend that proposed Section 1402(m)(1)(A) be revised to provide that "each shareholder of such disqualified S corporation who *(directly or indirectly) materially participates in* the professional service business referred to in subparagraph (C), shall take into account such shareholder's pro rata share of all items of income or loss described in section 1366 which are attributable to such business in determining the shareholder's net earnings from self employment."

C. Family Attribution Rule.

Proposed Section 1402(m) contains a family attribution rule, whereby an S corporation shareholder's pro rata share of NESE includes the pro rata share of items of income or loss of any member of such shareholder's family who does not provide substantial services to (or, as we would recommend, who does not materially participate in the business of) the S corporation. The provision authorizes the Secretary of the Treasury to specify exceptions where the general attribution rule would not be applied.

First, we believe that the relevant rule should similarly apply in the case of partnerships.

Second, on balance, a majority of the Committee would endorse a blanket application of the family attribution rule. Some members believe that the rule should be stated as, e.g., a rebuttable presumption, allowing shareholders/partners to avoid its presumptive application where it can be established (to the satisfaction of the Commissioner) that the acquisition of the relevant interest by a family member resulted from an arm's length transaction that was not designed to escape the application of payroll/self-employment taxes. We make certain recommendations below for the manner in which the provision could be revised to reflect such an approach.

We also recommend that in the cases where the attribution rule would apply, the self-employment tax would more properly be imposed on the relevant family member who owns the interest in the entity and thereby earns the related distributive share of income, and that a provision should be added to insure that income taxed under this rule by virtue of the Section 1402(m) is carved out of Section 1411.

Finally, we observe that the attribution rule as drafted would apply only in cases where both the service provider and members of the service provider's family own equity in the relevant entity; we recommend that the rule also apply in cases where the service provider owns no equity in the relevant entity.

D. Definition of PSB:

The definition of PSB contains a "substantially all" threshold, referring to "any trade or business if substantially all of the activities of such trade or business" involve services in the designated fields. "Substantially all" is not defined specifically for this context. We believe that this terminology brings unnecessary confusion into the scope of the PSB definition. We note that an entity can be engaged in multiple businesses, and indeed proposed Section 1402(m)(1)(A) refers, in the case of an S corporation, to the items of income "attributable to" such trade or business. For this reason, we believe that the definition of PSB should simply refer to "any trade or business involving the performance of services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services."

Further, we believe that it would be appropriate to expand the definition of covered activities from simply a PSB to cover other service fields, even if not "professional" services, which are not capital intensive.

E. Equalizing the Treatment of S corporation Shareholders and Partnership members; Proposed Section 1402(m)(2).

Proposed Section 1402(m)(2) provides that Section 1402(a)(13) (which generally excludes from the definition of NESE a limited partner's distributive share of income or loss) shall not apply to any partner who provides substantial services (which standard, as noted above, we would change to a "directly or indirectly materially participates" standard) with respect to the partnership's PSB. Given that Section 1402(m)(1)(A), in the case of an S corporation shareholder, would treat as NESE only the amounts of income or loss "attributable to such business", we believe a change should be made to proposed Section 1402(m)(2) in order to achieve the same result for partners in a partnership. In other words, we do not believe there is any reason to treat a distributive share of other income (not attributable to a PSB) as NESE in the case of a partnership, but to exclude such amounts when calculating NESE under Section 1402(m)(1)(A) in the case of an S corporation.

F. Relevance to Current Law or Situations Not Covered

The effective date provision contained in the House Bill refers to tax years beginning after December 31, 2010. Current law would apply to all tax years outside the scope of the effective date provision, and to all taxpayers whose business activity (and related income) involves a trade or business that is not within the defined scope of professional service businesses. We believe that neither the Internal Revenue Service nor any taxpayer should draw inferences from the proposed legislation when examining the question of whether reasonable compensation for services was paid in a past year or in relation to activities that are not covered by the proposal, and that legislation history in connection with any further consideration of the proposal should so provide.

II. The Proposal-Background and Current Context

The Proposal reflects Congress' most recent attempt to address a significant gap and area of uncertainty in the tax law, one that has allowed individuals conducting the same business activity (and earning essentially the same type of income) to pay materially different amounts of self employment tax based simply on their choice of business form; i.e., whether a sole proprietorship, S corporation, partnership, or limited liability company is used as the entity through which to conduct the relevant business. The resulting artificial disparity in tax treatment has been acknowledged as being unwarranted for some time, as reflected by the number of past recommendations by Congress, the Joint Committee on Taxation, and previous Administrations to revise the self employment tax rules in order to address this loophole.[4] In addition, a number of State Bar Association groups and other legal experts have, over a

[4] Some of these proposals are summarized in the attached Appendix. They include proposals made in 1993 as part of the Health Security Act, proposed regulations issued in 1997 that would have defined "limited partner" for purposes of the self-employment tax (these Regulations have not been adopted, and a moratorium was imposed by Congress in 1997), and a 2005 Joint Committee on Taxation recommendation included in "Options to Improve Tax Compliance and Reform Tax Expenditures". *See* Appendix.

period of many years, expressed their view that this topic should be addressed in order to achieve a fair and more coherent application of the payroll tax.[5]

Under current law, taxes are imposed on wages under the Federal Insurance Contribution Act ("FICA") and on earnings from self employment under the Self-Employment Contributions Act ("SECA"). FICA has two components (and is imposed on both the employer and the employee), a combined 12.4% tax on wages, up to a cap, and a 2.9% tax on wages which is uncapped.[6] Half of the FICA tax is deducted from the employee's wages. SECA is the analogue to FICA for the self-employed.[7] The Joint Committee on Taxation's explanation of the revenue provisions contained in the House Bill includes a detailed description of payroll taxes under current law as they apply to partners and S corporation shareholders.[8]

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[5] For previous reports of the NYSBA Tax Section, *see* "Report on the Self-Employment Tax as Applied to Owners of Interests in Pass-Through Entities", Dec. 6, 1994 (the "NYSBA 1994 Report") (commenting on House and Senate Proposals introduced on this subject in 1994) and NYSBA Report No. 1097 "Comments on JCT Recommendation relating to Employment and Self-Employment Taxes of Partners, LLC Members and S Corporation Shareholders", September 23, 2005 (the "NYSBA 2005 Report"). In addition, the NYSBA Tax Section provided comments on the 1997 Proposed Regulations dealing with the definition of "limited partner" for purposes of Section 1401 in a report dated March 17, 1997 (the "NYSBA 1997 Report").

See also "Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity", prepared for a public hearing before the Senate Committee on Finance by the Joint Committee on Taxation, June 4, 2008, pp.57-72; Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stanford Law & Policy Review 127 (2009); State Bar Ass'n of California, Los Angeles County Bar Association Report dated May 18, 1998 (reprinted 98 TNT 141-50). The Los Angeles County Bar Comments dating back to 1998 stated "[i]n order to avoid fundamental unfairness and widespread avoidance of Social Security Taxes, it is essential under fundamental tax reform to adopt some uniform method for determining "net earnings from self employment" resulting from interests in different forms of entities." *Id.*

[6] *See* Section 3101(a), Section 3111(a).

[7] The relevant SECA employment tax provisions are contained in Section 1401 of the Internal Revenue Code of 1986, as amended (the "Code"). Section 1401 imposes a two-tier tax on self-employment income. The old age, survivors and disability insurance portion of the tax is imposed at a 12.4% rate, up to a cap (currently the cap, for 2010, is $106,000). The Medicare portion of the tax, which is not capped, is imposed at the rate of 2.9%. Individuals can deduct half of their self-employment tax in calculating adjusted taxable income.

[8] *See*, STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN 'THE AMERICAN JOBS AND CLOSING TAX LOOPHOLES ACT, May 28, 2010 (the "JCT 2010 Summary"), pp. 288-291. The JCT 2010 Summary includes references to a number

In relation to S corporations, the relevant tax under current law is FICA, and it is imposed only to the extent of a shareholder's wages for services. FICA generally does not apply to the distributive share of S Corporation income earned by a shareholder, unless such distributive share is re-characterized as disguised compensation.[9] For partnerships, the relevant tax under current law is SECA. FICA does not apply to partners who provide services because for tax purposes, as the Service has ruled, a partner who devotes time and effort to the partnership's business is not an employee.[10] While partners, like independent contractors, are subject to SECA on their distributive share of partnership income, there is an exclusion under Section 1402(a)(13) for a *limited* partner's distributive share of partnership income.[11] In terms of limited liability company members, who are neither general nor limited partners, the law is uncertain, because given the statutory reference to "limited partner" it is unclear whether a member of an LLC should be treated as a limited or a general partner, and what criteria are to be applied when making this a determination. One fundamental problem in the payroll tax area has been that in the case of partnership entities the application of the self-employment tax to partners and members of limited liability companies has depended upon distinctions that bear no relationship to the question of whether the partner/member is a 'service provider'. Instead, the tax treatment has (to date) remained focused on state law distinctions that have long been outdated. In 1997, the Service proposed adopting regulations that would have ended this incongruous result in the case of partnerships; the proposed regulations would have treated partners providing more than 500 hours of service (and, in the case of service partnerships, more than a de minimis amount of services) as not being eligible for "limited partner" status for purposes of Section 1402. The 1997 proposed regulations were not adopted; Congress imposed a moratorium

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of cases where the Service has challenged taxpayer positions because the taxpayer/shareholders of S corporations did not receive reasonable compensation for services rendered. See footnote no. 694.

[9] See Rev. Rul. 59-221, 1959-1 C.B. 225; see also references in IRS Pub. No. 533, Self-Employment Tax (2004) at 9.

[10] Rev. Rul. 69-184, 1969-1 C.B. 256.

[11] This exclusion does not apply to guaranteed payments described in Section 707(c) to the extent such payments are in the nature of remuneration for services provided to the partnership.

preventing the Service from adopting regulations dealing with the self-employment tax treatment of limited partners.[12] Since the 1997 moratorium, some taxpayers believe they can easily avoid self employment taxes simply by choosing to run their business through an LLC, even if they themselves manage the LLC.[13]

The Proposal would make a number of changes to the application of SECA in the case of income derived from a professional service business. These changes are, in our view, long overdue. First and most importantly, the proposal would end the incongruous discrepancy in the employment tax treatment of business income earned through entities classified as partnerships for tax purposes; the application of the self-employment tax would no longer depend on whether someone is a limited partner, general partner, or LLC member, but rather on the extent of services that person provides to the partnership. Second, the Proposal would largely conform the payroll tax results for an S Corporation shareholder who provides substantial services to those that would apply if the entity conducting the business activity had been a partnership. In the case of S corporations that fall within the scope of the new statutory provision, the S corporation shareholders who provide substantial services would continue to be subject to FICA on actual wages they earn from the S corporation (as under present law); but, in addition, they would be required to include any distributive share of residual income earned from the S corporation as NESE subject to SECA. Certain items of income that are currently excluded from NESE (dividends, interest, certain rental income and certain capital gains) would retain their character as such and would not be subject to SECA.

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[12] This moratorium was imposed as part of the Taxpayer Relief Act of 1997, P.L. 105-34. See Appendix.

[13] It has been noted that in some instances, LLCs may elect to be taxed as S corporations, because the members of the entity believe that by so doing they will lessen the payroll tax questions that might arise in the partnership context. Furthermore, it is not uncommon for partners to hold a very small general partner interest and a large limited partner interest, and to take the position that self employment tax is owed only with respect to the small distributive share allocable to the general partner interest.

We endorse the approach taken by the Proposal. We also believe the proposal, as far as it extends, achieves a rationalization of the payroll tax treatment of flow-through entities that is consistent with the underlying premise of the taxation of S corporations as reflected in the legislative history. When subchapter S was first adopted, a shareholder's pro rata share of the income from the entity was characterized as a dividend. In 1982, as part of the Subchapter S Revision Act (P.L. 97-354), Congress revised the rules under Section 1366 to provide for flow-through character of the income. At that time, the legislative history stated as follows:

> "*As with the partners of a partnership,* each shareholder of a subchapter S corporation will take into account separately his or her pro rata share of items of income, deduction, credit, etc. of the corporation. These rules *parallel the partnership rules* under Section 702."[14]

In 1996, as part of the Small Business Job Protection Act, the ordering rules for determining adjustments to a shareholder's tax basis in an S corporation (in terms of dealing with distributions made during the year, and losses at the end of the year) were revised; the Committee Report at that time expressed the reason for the change as being an intention to have the rules operate in the same way that they would in the partnership context.[15] Thus, a key concept in the taxation of S Corporations (and the tax treatment of the entity's income and losses, in the shareholder's hands) reflects the express recognition by Congress that S corporations, as flow-through entities, should essentially be treated like partnerships. The Proposal would, insofar as professional service businesses and self employment taxes are concerned, further this intent.

This principle of consistent tax treatment between S corporations and partnerships is reflected in other Code provisions. For example, Section 1372 treats an S corporation as a partnership for purposes of the employee fringe benefit rules. Under the Section 318 attribution rules, Congress saw fit to treat S

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[14] S. REP. No. 97-640, and H.REP. No. 97-826 on P.L. 97-354 (The Subchapter S Revision Act of 1982); as reprinted in CCH federal tax reporter para. 32,080 (1982), (emphasis added). *See also*, Winchester, supra note 5, footnote 42.

[15] S. REP. 104-281, p. 56 (1996) (This report addressed PL 104-188, The Small Business Job Protection Act of 1996).

corporations like partnerships; share ownership to and from an S corporation and its shareholders is attributed in the same manner as it would have been if the S corporation were a partnership.[16] We are aware that for certain Code provisions, an S corporation's status as a corporation is recognized (S corporations are treated as regular corporations for purposes of the reorganization provisions of the Code, for example.) The legislative history to Section 1371, a statutory provision that refers to "coordination with subchapter C", provided as follows:

> "Provisions relating to transactions by a subchapter S corporation with respect to its own stock will be treated as if the S corporation were a regular corporation. However, the subchapter C rules are not to apply where the result would be inconsistent with the purpose of the subchapter S rules to treat the corporation as a pass-through entity."[17]

On two previous occasions, the Tax Section has submitted comments on past proposed legislative measures that addressed the self employment tax and its application to flow-through entities (in one case, commenting on the Administration's 1993 recommendation and the Senate Finance Committee recommendations in 1994, in another case commenting on a recommendation made by the Joint Committee on Taxation in 2005).[18] In both Tax Section reports, we expressed our view that there is no justification for artificial discrepancies in the application of "payroll taxes" on earnings from self employment. In our opinion, the same types of business activity and income should be subject to the same amount of payroll tax regardless of the choice of entity selected by a taxpayer. We remain committed to that principle, and believe the self employment tax/payroll tax rules should be conformed across the board for S corporations, general and limited partnerships, limited liability companies and sole proprietorships. As stated in the Tax Section's 2005 Report, "[t]he adoption of a single consistent rule

[16] Section 318(a)(5)(E).

[17] H.REP. 97-826 and S. REP. No. 97-640 on P.L. 97-354.

[18] *See supra*, note 5, NYSBA 1994 Report and NYSBA 2005 Report.

applicable to all owners of pass-through entities would, as the Joint Committee on Taxation notes, enhance horizontal equity and discourage tax-motivated choices among different business forms."[19]

Given the long-standing nature of the loophole, and the fact that prior attempts to close it have not been adopted, the Proposal has been characterized as representing a "tax increase"[20]. We would suggest, however, that a proposal that attempts to eliminate, or to reduce, opportunities to take advantage of a tax loophole is not a "tax increase"; rather, it is a measure that would work toward ending the implicit "tax penalty" imposed on those who are tax compliant and have long borne an unfair share of the tax burden, and one that would impose a more consistent application of the payroll tax to the same type of business income.

Further, under current law, in the case of an S corporations, the Internal Revenue Service can challenge taxpayer positions and assert deficiencies where it believes that a company has failed to "reasonably compensate" a shareholder/employee for services (i.e., that the entity is disguising such compensation in the form of distributions). In addition, under Section 1366(e) of the Code, which provides for the pass-through treatment of each S corporation shareholder's distributive share of income, the Service is expressly authorized to re-characterize the distributive share of a "service provider's" as well as any member of that person's family as representing compensation, if such adjustments would reasonably reflect the value of the services rendered. Thus, it could be argued that the Proposal would not materially alter the intended application of payroll taxes under current law (at least in the case of S corporations engaged in professional service businesses), but rather would eliminate the need to prove

[19] NYSBA 2005 Report, *supra* note 5, p.3

[20] For example, *see* Martin Vaughanan, *Payroll Tax Increase Dropped from Senate Bill*, The Wall Street Journal online edition, July 29, 2010, and Dean Zerbe, *Senate Proposal Pits IRS against Small Business*, Forbes online, June 17, 2010 (referring to the payroll tax "hike").

that the compensation is "reasonable" on a case by case basis.[21] A case by case approach is costly, administratively cumbersome, and inevitably leads to disparate results for similarly situated taxpayers.

The principal objections to the Proposal have, to date, focused on S corporations, and on the fact that (i) earnings which are not paid out as compensation (but are reinvested in the business) would be subject to self-employment taxes, and (ii) the proposal would tax a return on "capital," as opposed to labor income. We do not believe these concerns are valid, particularly given the targeted approach of the legislation in its application only to service businesses. Furthermore, we believe the proposed treatment of S corporation shareholders under the Proposal is a natural outgrowth of the flow-through tax status of these entities, which is an elective classification.[22] As in the case of partnerships and sole proprietorships, the mere fact that earnings that essentially represent a payment for services are "reinvested" in the business does not mean that those earnings should avoid the imposition of payroll taxes. The Proposal would treat those shareholders who provide substantial services to a "professional service" S corporation in the same way that current law treats general partners and sole proprietors.

The Proposal would apply to a specified universe of "professional services businesses" that are generally understood not to be capital intensive. For this reason, we do not believe the proposed legislation converts an income stream that principally represents a return on "capital" into labor income.[23]

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[21] There are instances where an allocable share of S corporation income may reflect a return on an intangible such as goodwill; in such cases the Proposal would extend its reach further than current law in treating the entire return as income subject to self employment tax.

[22] Section 1362 of the Code provides that a small business corporation "may" elect to be treated as an S corporation. In the absence of such an election, the entity would be treated as a "C corporation" (if it is incorporated), or else, depending on the form of the entity, as a partnership (a limited liability company that meets the ownership tests of section 1361 could elect to be taxed as an S corporation; in fact, it is our understanding that some LLCs make this election precisely in order to minimize the application of payroll taxes).

[23] In previous Tax Section reports, we observed that given differences in the taxation of labor income and income from invested capital, in a pure sense one could argue that an income stream reflecting a pure return on capital should be isolated and treated as such. Our past comments have also questioned whether a "service provider" partner should be precluded from making a capital investment and earning a return on capital in the same way that a non-service providing limited partner would be able to. However, these comments related to legislative proposals

Discussion of Recommendations on Proposal

A. Disqualified S Corporations- definition.

The Proposal would apply only to a specified subset of S Corporations, namely "Disqualified S Corporations" ("DSC"s). As defined in Proposed Section 1402(m)(1)(C), an S corporation is a DSC if (1) it is a partner in a partnership which engages in a PSB *and* substantially all of such S corporation's activities are performed in connection with that partnership (the "DSC-Partnership Test"); or (ii) if the S corporation is engaged in a PSB *and* the principal asset of such business is the reputation and skill of three or fewer employees (the "DSC-Skill Test"). In response to the proposed definition of DSC, we make the following recommendations:

1. The DSC-Partnership Test.

Where an S corporation is a partner in a partnership that is itself engaged in a PSB, we do not see any reason to limit the application of the rule to cases where "substantially all" of the S corporation's activities are performed in connection with such partnership. Instead, we would recommend that the rule

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with a much broader scope, where all business entities would have been covered, not just 'service businesses'. We noted, in providing these comments, that in the case of service businesses the concern over having to separate income that reflected a return on capital was not a major concern. *See supra, note 5*, NYSBA 1994 Report, and NYSBA 2005 Report.

We especially note that recent history-- particularly the proposals made in relation to the carried interest in investment partnerships-- have served to highlight just how complex any attempt to differentiate between income representing a return on capital and income representing a payment for labor can become. *See,* NYSBA Tax Section "Report on Carried Interest and Fee Deferral Legislation", September 24, 2008. Additionally, where a person (or a shareholder group) does not want to incur the tax obligations that are a natural outgrowth of flow-through entity status, they do not need to elect S corporation status – they could simply be taxed like a regular "C corporation" (in the case of a C corporation, undistributed income is taxed at the corporate level but is not subject to self employment tax if it is not paid out in the form of wages-- the Proposal, notably, would not apply to C corporations.)

be revised to treat any S corporation that holds an interest in a partnership that is itself engaged in a PSB as a DSC.

A PSB, by definition, earns its income in the form of compensation for services rendered. Any portion of fee income that passes through to partners of a partnership engaged in a PSB (including, in this case, the S corporation partner) should not lose its character as compensation for services, regardless of whether "substantially all", only 30% (for argument's sake), or *any* of the S corporation's activities are performed in connection with that partnership. The "attributable to" limitation in the Proposal already ensures that only the PSB portion of any flow-through amount would be subject to SECA tax.[24]

Further, the DSC-Partnership test appears to assume a situation where an individual service provider engages in business through an S Corporation as a member of only one partnership. However, it is possible to imagine cases where a shareholder/service provider, or a group of individual service providers, act through an S Corporation in providing services to several partnerships. This could occur, for example, in connection with the same business activity, but where the partnerships are established as separate entities based on the make-up of the partners, and/or the geographic location of the activities carried out. As currently formulated, these individual service providers would not be subject to the Proposal simply because there are multiple partnership entities involved.

We believe that proposed Section 1402(m)(1)(A), referring to "all items of income or loss…attributable to such business" should be read to cover the portion of the distributive share of S corporation income (earned by the S corporation shareholders) reflecting income derived from the relevant partnership. Applicable regulations could further clarify this point. Thus, we recommend that the final version of the Proposal delete the reference to the "substantially all" standard currently contained in the DSC-Partnership definition.

2. The DSC-Skill Test.

[24] See Proposed Section 1402(m)(1)(A).

We recommend that the dual requirement that an S corporation must be both engaged in a PSB *and* that such business must depend on the skill and reputation of a certain number of employees should be eliminated. Furthermore, we recommend the requirement that the "principal asset" of the S corporation's business must be the skill and reputation of the employee(s) should similarly be eliminated. To the extent the concept of businesses dependent on the skill or reputation of employees is to be incorporated in the Proposal, it would more appropriately be referenced in connection with the definition of a PSB (by authorizing Treasury to expand the defined category of businesses to include other service businesses dependent on the skill or reputation of one or more employees). In previous legislative proposals that similarly aimed to apply to "service businesses,"[25] the statutory provisions were written to cover a list of enumerated professions[26] *as well as* "any trade or business where the principal asset is the reputation or skill of one or more of its employees." A subsequent Senate Bill[27] modified the definition somewhat;[28] however, it preserved the "either/or" feature with a residual definition. In other words, to the extent this second threshold test as reflected in the Proposal is a relevant concept, it is more properly something that should modify (and possibly, serve to expand) the defined category of PSBs. [29]

[25]*See* The Health Security Act, introduced November 1993, as H.R. 3600, S.1757 and 1775. 103d Cong., Section 7141.

[26]Specifically, "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services…"

[27] S.2357

[28] The Senate Finance Committee's definition of "service-related business" excluded, 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. The residual definition of "service-related business" was "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."

[29] In addition, we note that Section 1202 of the Code (exempting certain gain from the sale of small business stock from tax) currently defines a "qualified trade or business" as any trade or business other than "(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, ***or*** any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees*."*

We also believe, putting aside the reference to the reputation or skill of "three or fewer employees," that the additional threshold test is redundant; the trades and businesses that comprise the definition of PSBs implicitly reflect businesses where the employees (and the labor they provide, as opposed to capital or equipment utilized) are the primary source of the business' value and its earnings/income.

We have additional concerns with the manner in which this threshold test is drafted. First, the reference to those entities dependent on the skill or reputation of *three or fewer employees* seems entirely arbitrary and vague. It is not clear why the incidence of the Proposal should be affected by the number of the company's employees upon which the business depends. A professional services business earns its income in the form of fees for services rendered. That is true whether the business depends upon the skill of one, three or five (or more) employees. Perhaps the drafters had in mind a sole service provider who is converting his compensation for services into dividends (or a distributive share of income) by carrying on his business through an S corporation, and thought that this more brazen behavior would be less likely in a larger organization, with more controls in place to ensure at least a minimum standard of tax compliance.[30] Regardless, the inclusion of the "three employee or less requirement" seems to be arbitrary and would invite abuse by, e.g., encouraging formation of slightly larger businesses to avoid the SECA tax. An architecture firm with five architects should not escape application of the rule simply because there are five key service providers; otherwise, the requirement would unfairly favor larger organizations over smaller ones. Further, the rule as drafted raises significant uncertainty; in this example, would the architecture firm be required to make a determination of whether its "principal asset" is the skill or reputation of three of the five architects? Such line-drawing and value judgments seem entirely ill suited to the context.

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[30] This concept also may be based on certain statistical information regarding the distribution of S corporations by number of shareholders. Based on returns filed in 2007, only 3.55% of reporting S Corps have more than three members (three or less members: 1,428,679; four or more members: 50,769). See STATISTICS OF INCOME DIVISION, INTERNAL REVENUE SERVICE, S CORPORATION NUMBER OF RETURNS, BY NUMBER OF SHAREHOLDERS AND INDUSTRIAL SECTOR (2010), available at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96405,00.html (last visited Sep. 10, 2010).

As our previous comment reflects, we are troubled by (and disagree with) the reference, within this second threshold test, to the notion of the "principal asset" of the S corporation being the skill or reputation of some number of its shareholders/employees. This reference is vague and could be read to imply a corporation must make some determination of the relative value of its assets on an annual basis, something that we do not believe was intended by the drafters.

Finally, we note there is no such additional threshold test that would apply in the context of a partnership entity engaged in a PSB.

For these reasons, we recommend that a DSC be defined to include *any* S corporation engaged in a professional service business. Any reference to businesses dependent upon the skill or reputation of a certain number of employees would more appropriately be incorporated into the definition of PSB, as a possible expansion of the defined list of businesses. The Proposal is targeted at S corporations where the skill and reputation of the employees is the primary income-producing factor for the trade or business; the language of the Proposal should clearly reflect this goal.

B. Meaning of Substantial Services.

Proposed Section 1402(m) applies only to those S corporation shareholders, or partners (in the case of a partnership entity) who "provide substantial services with respect to the professional service business" (subject to a family attribution rule, as discussed below). We recommend that this standard be replaced with a standard that refers instead to whether the relevant shareholder (or partner) "materially participates" in the entity (again, subject to a family attribution rule). We make this recommendation because we believe the reference to "substantial services" imposes a vague standard, one whose meaning will be left open to differing interpretation, and because a "material participation" standard tied to the material participation test found in the Section 469 regulations will provide greater clarity in the application of the proposed rule.

Under Temporary Treasury Regulation 1.469-5T, an individual (other than a limited partner) is treated as materially participating in an activity for the taxable year if:

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including non- owners) for such year;

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

(4) The activity is a "significant participation activity" for the taxable year, and the individual's aggregate participation in all "significant participation activities" during such year exceeds 500 hours;[31]

(5) The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a "personal service activity" (e.g. health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable 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 such year.

Previous House versions of self-employment tax reform bills on which we have commented had recommended "material participation" as the relevant standard, but have not defined the phrase. In 1994, we suggested that the general Section 469 definition of material participation should be adopted as the standard for "material participation" with respect to the Health Security Act of 1993. In our NYSBA 2005 Report, with respect to the 2005 Joint Committee on Taxation's recommendation[32], we reiterated

[31]Generally, a significant participation activity is a trade or business in which an individual participates for more than 100 hours during the year but with respect to which the individual does not satisfy any of the other tests for material participation. Temp. Treas. Reg. 1.469-5(c).

[32] See Appendix for description of 2005 JCT proposal.

our support for use of the Section 469 definition of material participation standard (with certain modifications) as the relevant standard for "material participation."[33]

The Proposal has not adopted the material participation standard of the previous proposed bills, but has referenced a "substantial services" standard.[34] The House Bill does not provide any indication of the meaning of "substantial services." We believe that this reference to "substantial services" should be replaced with a reference to the material participation found in the Section 469 regulations. We further believe that the material participation standard should apply without modification. Such an approach would provide consistency with the passive activity loss rules, and will be a standard that is easier to administer. Notably, the approach is also consistent with the relevant determination made under Section 1411, where "net investment income" is defined to include only gross income derived from a trade or business that is a passive activity, within the meaning of Section 469, with respect to the taxpayer.[35]

The Section 469 material participation test reflects a methodology for distinguishing active participants from passive investors which the Treasury Department and the Service have adopted for some time. In order to have a workable rule to exempt capital providers who do not provide significant services, the Section 469 test of material participation should produce sensible results in the Proposal context. In the past, some have commented on whether certain aspects of the material participation test can be appropriately applied in the context of payroll taxes (given, for example, the look-back rules). On balance, we believe that in the case of service businesses the material participation rules relevant under Section 469 should apply in their entirety. The underlying premise of the Section 469 regulations was

[33]In proposing modifications from the Section 469 definition of material participation, we suggested that Treasury Regulation Sections 1.469-5T(a)(5) and 1.469-5T(a)(6) (the tests based on material participation in prior years) should not apply for SECA tax purposes. We further suggested that the material participation test would need to be clarified insofar as it might apply to partners who were formerly employees.

[34]A "provides significant services" standard was proposed in the Senate version of the Health Security Act of 1993, but no details were provided in the text of the bill or Senate committee report regarding the meaning of the phrase.

[35] See Section 1411(c)(1) and (c)(2).

that where an individual materially participated in an activity over a period of time, a withdrawal from that business should not convert the earnings into passive income, a pro-taxpayer rule. We believe that consistency in this context would have some merit.[36]

Use of the existing Section 469 material participation rules would also avoid the necessity of developing a new test for use in the Proposal context, removing what is likely otherwise to impose a substantial burden on Treasury, the Service and taxpayers, when it comes to application and administration of the new provision. Finally, use of the existing Section 469 material participation rules would foreclose an individual from claiming material participation in order to avoid a passive loss limitation, while simultaneously arguing that she did not provide substantial services for self-employment tax purposes- an analytically inconsistent position.[37]

We believe that, both in the case of partners and S corporation shareholders, where tiered entity structures are involved a member of an upper tier entity who "materially participates" (assuming this standard were to be adopted) in the lower-tier entity's PSB will be subject to the applicable provisions. Proposed Section 1402(m) authorizes the Secretary to prescribe regulations that are necessary or appropriate to carry out the purposes of the provision, and we would expect that applicable regulations will further clarify the appropriate result in the case of tiered structures.

C. Family Attribution Rule

Proposed Section 1402(m)(1)(B) provides that, in the case of an S corporation to which the rules apply, "except as otherwise provided by the Secretary of the Treasury, the shareholder's pro rata share of items" that will be treated as NESE shall be increased by the pro rata share of any such items of each

[36] A strict application of the Section 469 regulations in this context would mean that, in the case of service businesses, a person who materially participates for three years will be subject to SECA on any income that he or she derives from that business in future years. An alternative would be to subject future income (in years where the individual meets the material participation test only as a result of the three year lookback provision)to SECA that if the income is derived (whether or not deferred) during years in which substantial services are or were performed.

[37] This inconsistent position could result if the Section 469 regulations are not accepted in their entirety.

member of such shareholder's family who does not provide substantial services to the entity. A shareholder's family has the meaning set forth in Section 318(a)(1).[38] We will refer to this provision as "the Family Attribution Rule."

We believe that, given the category of service businesses included in the definition of PSB, it may be the rare case where a family member makes an arm's length capital investment in a business of this nature. We also understand that ownership shifts to family members can (and are) utilized in this context in order to escape payroll taxes.

The first comment we have regarding the Family Attribution Rule is that we believe the statutory provision unintentionally omitted to apply a similar family attribution rule in the case of partnerships. Given the apparent goal of the proposed legislation to conform the treatment of S corporation shareholders and partners, to the extent a Family Attribution Rule is imposed, a similar rule should be imposed in the case of an entity taxed as a partnership.

We are somewhat divided on the application of the Family Attribution rule in this context. A majority of the members of our Executive Committee endorse a blanket application of this rule (consistent with the draft statutory provision) given the targeted scope of the Proposal in its application to non-capital intensive businesses, and the apparent underlying premise of the rule: that in the case of a PSB, all members of a family are essentially treated as one for self employment tax purposes. These members of our Committee believe that since a service provider who invests in the business would be subject to payroll tax on their full distributive share (in the same way that a general partner is treated under current law), there should be no opportunity to escape the rule by having a family member invest the capital in the business. These members also observe that it is possible for family members to extend loans to the entity, thereby avoiding the application of the provision (assuming that the loan is respected as a loan and not as a disguised form of equity). Finally, we note that many taxpayers would be subject to

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[38] Section 318(a)(1) refers to a person's spouse, children, grandchildren and parents.

tax under recently enacted Section 1411 even if their interest were to fall outside the scope of the Family Attribution Rule. For these reasons, a majority of the members of our Executive Committee believe that the Family Attribution Rule should be applied without exception.

Some other members would recommend that the statutory provision be revised to limit its application to cases where there is a plan to shift income to a non-service provider, in order to avoid self employment tax. Such a plan could be presumed to exist unless the taxpayer can establish otherwise in accordance with regulations issued by the Secretary of the Treasury. The Secretary could be authorized to issue regulations addressing the relevant facts and circumstances that will be weighed in cases where a taxpayer intends to rebut the presumptive application of this provision. However, given the fact that any exception to the general rule is likely to invite abuse, we believe that any exceptions to the Family Attribution Rule should be narrowly delineated.

If the applicable regulations are to allow for exceptions, with examples, the regulations could further identify facts and circumstances that would be relevant in rebutting a presumptive application of the rule. These facts and circumstances could include consideration of the following:

i. Cases where the issuance of shares to a family member is the result of an arm's length investment in the company or partnership, as evidenced by contemporaneous transactions with unrelated third parties. A consideration that might influence the weight of this factor would be the percentage of 'outside' interests. In other words, one variation would be to provide that a minimum amount (by percentage) of interests must be acquired by unrelated third parties in order for this fact to count as a "good fact" for purposes of rebutting the presumption;

ii. Cases where the issuance of shares to the family member is proportionate to the interest held by the service provider, by reference to each person's capital investment in the company or partnership, as long as it can be proved that the family member who is a service provider (and is subject to proposed Section 1402(m)) is receiving reasonable compensation for services;

iii. Cases where the percentage of shares or partnership interests held by a family member (who is not a "substantial" or "material" service provider) is de minimis (e.g., less than 2%).

This suggested approach would allow certain shareholders and partners to avoid a conclusive application of the family attribution rule. Given the ease with which family interests can be shifted in these cases in order to avoid SECA, however, we believe any such exceptions should be narrow. Furthermore, we suggest that in cases where a shareholder or partner believes that he/she is able to rebut the presumption, they should be required to disclose the position in appropriate detail on their tax return for each year in which it is relevant to the calculation of SECA tax liability.

We have also considered whether the self-employment tax obligation should rest with the service provider (as the rule in the proposed legislation currently provides), or rather on the member of the family who owns the relevant interest and thereby derives the economic benefits of ownership. As drafted, Section 1402(m)(1)(B) would increase a service-provider shareholder's share of income subject to the self-employment tax by the pro rata/distributive share of items of income or loss of each member of the shareholder's family. On balance, we believe the tax should be imposed upon the shareholder who has earned the distributive share of income (even if that person is not a service provider). This would create, in our opinion, a more administrable rule, particularly as there may be instances where within a single family there are two or more "service providing" shareholders or partners. In such a case, the rule as drafted fails to specify which of the service providers would be liable for the tax. We believe that imposing the tax obligation on the person who has earned the pro rata share of the income would aid in a more rational application of the tax, and that, as an economic matter, this approach is more just. This could be accomplished by revising the provision to state that where a service provider falls within the scope of the applicable rules (by virtue of being a substantial service provider, or, as we would suggest, a material participant in the PSB), any member of that person's family (within the meaning of Section 318(a)(1)) who owns an interest in an entity engaged in the relevant PSB shall be required to take into account his/her pro rata share of all items of income or loss that are attributable to such PSB as net earnings from self employment for purposes of Section 1402, as if the amounts had been realized directly by a service provider.

Finally, as written, the proposed legislation provides for application of the family attribution rule only where family members A and B both hold equity in the entity, and A provides services but B does not. The same concerns addressed by the family attribution rule could arise in a case where A (the service provider) does not own any equity in the entity to which A provides services. We believe that the application of SECA to B's distributive share should not depend on whether A owns one share, or no shares, in the entity, and the theoretical premise of the family attribution rule would seem equally relevant regardless of the extent of share ownership by the service provider. Thus, we recommend that where a person materially participates in the PSB, any member of that person's family should be required to include all items of income or loss as "net earnings from self employment".

D. Definition of Professional Service Business.

Proposed Section 1402(m)(3) defines a professional service business as follows:

> "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"

The reference to "substantially all" in the definition of a PSB is, in our view, unnecessary and may give rise to inappropriate planning and disputes. As discussed below, we think that the proper result can be achieved simply by referring, in the definition of PSB, to "any trade or business involving the performance of services" in the enumerated fields.

There are other provisions in the Code where "substantially all" is referenced in relation to a determination that is tied in some manner to the provision of services, and in these cases the reference test is one that applies to the entity as a whole. For example, under Section 448 a "qualified personal service corporation" is allowed to use the cash method of accounting if it meets a function test and an ownership test. The function test is tied to whether "substantially all" of the services of the entity fall into certain specified fields. The applicable Regulations address the meaning of "substantial services", providing that the test is satisfied only where 95% or more of the "time spent" by employees every year (in their capacity as such) is devoted to performing services in the relevant field. Another example can be found in Section 41 of the Code, which provides for a research tax credit and defines "qualified research" by reference to the nature of certain activities carried on. Section 41(d) refers to whether "substantially all" of the activities constitute a process of experimentation. Applicable regulations provide that the "substantially all" requirement is met only if 80% or more of a taxpayer's activities, measured on a cost or other consistently applied reasonable basis constitute elements of a process of experimentation.[39]

These other examples are provisions in the Code where an entity's overall eligibility for a specific benefit is being tested; for example, a credit that offsets taxable income, or the ability to use the cash method of accounting in the case of a C corporation. In contrast, proposed Section 1402(m) references "a" trade or business. Furthermore, Section 1402(m)(1)(A) refers, in the case of an S corporation, to items of income or loss "attributable to" such business as being treated as net earnings from self employment. Section 1402(m)(1)(A) does not mandate an all-or-nothing test, or require that when an S corporation is engaged in a PSB, *all* of a service provider's distributive share of income would be treated as net earnings from self employment; only the income attributable to the PSB is required to be treated as NESE.

For these reasons, we recommend that the term PSB should be defined as "any trade or business involving the performance of services" in the specified fields. Further, we believe that it would be appropriate to expand the definition of covered businesses to include other non-capital intensive

[39] Treas. Reg. Section 1.41-4(a)(6).

businesses, as avoidance of the SECA tax is not confined to entities performing professional services and no logical distinction based on the classification of services as professional is apparent to us.[40]

E. Equalizing the Treatment of S corporation Shareholders and Partnership members; Proposed Section 1402(m)(2).

Proposed Section 1402(m)(2) provides that Section 1402(a)(13) (which excludes from the definition of NESE a limited partner's distributive share of income or loss) shall not apply to any partner who provides substantial services with respect to the partnership's PSB. In contrast to the language in subsection (m)(2), Section 1402(m)(1)(A) refers, in the case of a shareholder of a DSC, to amounts of income or loss "attributable to" the business as reflecting NESE.

We believe a key objective of the Proposal, at least with regard to PSBs, is to equalize the payroll tax results for the same business activity regardless of whether such activity is conducted through an entity classified as an S corporation or a partnership. We therefore recommend that that a modification be made to proposed subsection 1402(m)(2), in order to similarly take into account as NESE only the share of partnership income attributable to the relevant PSB. This could be accomplished by revising Section 1402(m)(2) to read as follows:

"In the case of any partnership which is engaged in a professional service business, subsection (a)(13) shall not apply to the distributive share of income or loss attributable to such business and allocable to any partner who [provides substantial services with respect to]/[materially participates in][41] *such professional service business."*

[40] The Senate Finance Committee Bill in 1994 defined "service related business" as "(A) any trade or business involving the performance of services in the fields of health (other than inpatient personal care facilities), law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, or financial services (other than lending or brokerage), or (B) any other trade or business with respect to which the Secretary determines that capital is an insignificant income-producing factor."

[41] The alternative bracketed language is meant to address our earlier comment regarding material participation as the suggested relevant standard for determining the class of persons to whom the rules would apply.

APPENDIX—SUMMARY OF SOME PREVIOUS RECOMMENDATIONS.

Below we have summarized in brief form certain prior recommendations dealing with the self employment tax and its application to flow-through entities. This is not comprehensive; a more comprehensive description of past proposals can be found in "Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity", prepared by the Staff of the Joint Committee on Taxation.[42]

1. 1993-1994 Legislative Proposals.

The Administration's Health Security Act of 1993[43] included a provision that would have required S corporation shareholders to include their pro rata share of income or loss from an S corporation as NESE, and that would have expanded the definition of NESE to address holders of limited partnership interests. For S corporation shareholders, the proposal would have applied to those holders of more than 2% of the S corporation who "materially participate" in the activities of the S corporation. NESE would have included the shareholders pro rata share of taxable income/loss from any service-related business, defined as "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 proposal would have rationalized the treatment for partners in partnerships, providing that a limited partner's distributive share of partnership items would be NESE if the limited partner materially participated in the business.

In July of 1994, the Senate Finance committee introduced a bill that modified the proposal contained in the Health Security Act. Under the Senate Finance Committee's 1994 version, the "material participation" standard was replaced with a threshold standard tied to whether the S corporation shareholder (or the limited partner) provided "significant services" to, on behalf of, the entity. The Senate

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[42] JOINT COMM. ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY (June 24, 2008) (the "JCT 2008 Study") pp. 53-72.

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

Finance version also cut back the percentage of income that would be subject to SECA, to 80% from 100%. In addition, the Senate Finance version modified NESE by providing that any other trade or business which the Secretary of the Treasury determined was not a "capital intensive" business (described in the bill as a business where capital is an "insignificant factor" in the production of income) would fall within the scope of the bill (as opposed to the provision referred to above in the HSA that referred to businesses dependent on "reputation or skill of one or more employees"). Later that year, in August 1994, Senator George Mitchell introduced another bill that modified the manner in which NESE would be calculated, most notably by providing a limitation on the amount of income that would be includable as NESE equal to the lesser of (a) 30% of the Social Security "contribution and benefit base", or (b) the excess of such contribution and benefit base over the sum of the taxpayer's NESE for the taxable year.[44]

The NYSBA 1994 Report agreed that there should be a threshold test for purposes of determining to whom the rules should apply, and recommended that the standard should be a "material participation" standard. The report recognized that one might take issue with a less than perfectly "theoretically pure" approach-- in terms of a failure to bifurcate income representing a return on capital from earnings for employment/labor. Yet, at the same time the NYSBA 1994 Report acknowledged that the Senate Finance Committee Proposal had administrative advantages—an 80% test being "*relatively simple for both the government and taxpayers*". The report recognized as well the fact that establishing what portion of an owner's return is attributable to capital can, in practice, be extremely difficult. Certain alternative approaches were addressed, in terms of recommendations for possibly segregating amounts that represent a return on capital.

B. 1997 Proposed Regulations

[44] *See* S. 2357, and NYSBA 1994 Report, *supra* note 5, for more details on the 1993 and 1994 proposals.

In 1997, regulations were proposed dealing with the meaning of "limited partner" for purposes of Section 1402.[45] The regulations, which applied to any entity classified as a partnership, would have required any individual who: (1) had personal liability for the debts of or claims against the partnership by reason of being a partner; (2) had authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participated in the partnership's trade or business for more than 500 hours during the taxable year, to be treated as a general partner would be treated. State law distinctions between limited partners, general partners, and members of limited liability companies would not have had any effect on the manner in which a partner would be taxed for purposes of SECA. Where substantially all of the activities of a partnership involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, the 1997 Proposed Regulations provided that any individual providing more than a *de minimis* amount of services to or on behalf of the partnership would not be treated as a limited partner. The 1997 proposed regulations withdrew earlier proposed regulations on the same subject that had been issued in 1994.

The 1997 proposed regulations included provisions that would allow a partner who was otherwise prevented from being classified as a "limited partner" to be treated as a limited partner with respect to a class of interest if other partners (who were not material service providers, and therefore would be limited partners under the revised rules) held a substantial amount of an identical class of interests.

We submitted comments on the 1997 Proposed Regulations in a report dated March 11, 1997. We recommended that the sole determining factor should be the level of a partner's participation in the partnership, not whether the partner was liable for debts of the partnerships or had the authority to enter into contracts on behalf of the partnership. We objected to the presumption that any partner providing

[45] Proposed Treasury Regulation Section 1.1402(a)-2 (January 13, 1997).

more than de minimis amount of services was presumptively a 'material participant.' We also provided comments on the "bifurcation" rule, principally to the effect that it was too rigid in its application.[46]

The Taxpayer Relief Act of 1997 barred the Service from issuing temporary or final regulations on the meaning of the term "limited partner" for purposes of section 1402.

B. 2005 JCT Proposal

In 2005, the Joint Committee on Taxation proposed changes to the payroll tax provisions for partners and S corporation shareholders[47] (the "2005 JCT Proposal). The 2005 JCT proposal would have extended the current law rule for general partners to all partners, and to all S corporation shareholders, if such person(s) materially participated in the entity. The 2005 JCT proposal provided an exclusion from the application of NESE tax, in the case of "non-service businesses", for income such as dividends, interest, certain capital gains and rental income. However, in the case of a defined category of service businesses, the JCT 2005 proposal would not have applied this exclusion, taxing 100% of a partner or S corporation shareholder's distributive share as self employment income.[48] The proposal provided that for those members who were not "material participants", only amounts representing "reasonable compensation for services" would have been subjected to SECA. The NYSBA 2005 report provided comments on the JCT 2005 Proposal. Our principal comments at that time, recommending a bifurcated approach whereby payroll tax would only to that income stream properly attributable to "labor" is not relevant here, because the Proposal has adopted a targeted approach that would only apply to service businesses. As our 2005 report stated *"...full bifurcation is probably unnecessary for true service*

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[46] As stated earlier in this report, we do not believe the Proposal raises the same concerns due to its limited application to service businesses.

[47] JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 99-104 (January 27, 2005).

partnerships."[49] The JCT 2008 Study refers to a modified version of the JCT 2005 recommendation, made by then JCT Chief of Staff George K. Yin, that would have adopted a narrower scope, focusing on service businesses conducted through S corporations and partnerships.[50]

C. ABA/AICPA Proposal.

In 1999 the ABA submitted recommendations, together with the AICPA. This proposal was focused on the self employment tax rules and their application to partners, and would not have modified current law tax treatment for S corporation shareholders. A principal feature of the ABA proposal was that it would have provided for certain carve-outs, designed to exclude from the SECA tax income attributable to capital. The proposal suggested that safe harbors be adopted, referring to amounts that could be shown to exceed "reasonable compensation", or alternatively to amounts representing a "reasonable rate of return" on a partner's invested capital, and that such amounts be excluded from NESE (and treated as income attributable to capital.)[51]

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[49] 2005 NYSBA report, *supra* note 5, p. 19

[50] See JCT 2008 Study, p. 58

[51] See "ABA Tax Section Suggests Legislative Fix for LLC Self Employment Tax", 1999 TNT 133-23 (July 13, 1999).