Transforming Rental Income to Self-Employment Income
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Qualified Joint Ventures and Self-Employment Tax

Back last May Congress passed a provision in the *Small Business and Work Opportunity Tax Act of 2007* that allowed husband/wife owned LLCs and other qualified entities to elect to be treated as a "qualified joint venture." Most of the coverage of this provision concentrated on the fact that this would eliminate the need to file a Form 1065, but the provision required dividing income based on each spouse's share of the income. This provided appeared meant to provide a very rough equivalence with Revenue Procedure 2002-69, which allowed LLCs owned as community property by husband and wife to disregard the entity.

A less noticed part of Act Section 8215 was Act Section §8215(b) that made changes to IRC §1402 and §211 of the Social Security Act to redefine self-employment income.

In the instructions to the 2007 Form 1065, the IRS pointed out this change, which significantly impacts husband/wife owned rental properties in LLCs where the spouses wish to avoid filing partnership return—at least those outside community property states.

Qualified Joint Venture

The *Small Business and Work Opportunity Tax Act of 2007* Act §8215(a) added §761(f) to the Internal Revenue Code that provides the following new option for an entity already taxed as a partnership. That provision provides:

> §761(f) Qualified joint venture
>
> (1) In general
>
> In the case of a qualified joint venture conducted by a husband and wife who file a joint return for the taxable year, for purposes of this title--
>
> > (A) such joint venture shall not be treated as a partnership,
> >
> > (B) all items of income, gain, loss, deduction, and credit shall be divided between the spouses in accordance with their respective interests in the venture, and
> >
> > (C) each spouse shall take into account such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor.
>
> (2) Qualified joint venture
>
> For purposes of paragraph (1), the term "qualified joint venture" means any joint venture involving the conduct of a trade or business if--
>
> > (A) the only members of such joint venture are a husband and wife,
> >
> > (B) both spouses materially participate (within the meaning of section 469(h) without regard to paragraph (5) thereof) in such
> >
> > (C) both spouses elect the application of this subsection.

I had commented early on that this left a number of questions unanswered about

how this was going to be used and what couples that wanted to make use of the provision needed to do. Clearly some items, such as how to elect the treatment, needed IRS guidance and others, such as how we determine each spouse's "respective share" of the income or loss, seemed in need of clarification.

The IRS did give some guidance—but not in an official pronouncement, but rather in the instructions to Form 1065 (which, of course, is the form we won't be filing).

IRS Guidance

On page 2 of the Form 1065 instructions, the IRS outlines the general rule that business activities conducted in a form jointly owned by a husband and wife will create a partnership that requires the filing of a Form 1065. The instructions start out as follows:

> **Husband-wife business.** Generally, if you and your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership and you must file Form 1065.

The Joint Committee on Taxation's report on this provision in the *Small Business and Work Opportunity Tax Act of 2007* makes clear that §761(f) wasn't meant to change prior law in the basic determination of what is a partnership[1]—which also means that the above states what has always been the law.

Note that this didn't necessarily mean a partnership had to be filed for each husband/wife LLC—if the entity did not meet the basic requirements to be a partnership under the IRC—for instance, an LLC that did not carry on a "business, financial operation, or venture" as required by §7701(a)(2).

As well, even if an entity cleared that hurdle, it could still attempt to qualify to avoid filing a partnership return by electing out of partnership treatment if it qualified under §761(a). That would allow a husband wife partnership that was formed for "investment purposes only" and not for the "active conduct of business" to elect out of Subchapter K (and partnership treatment) if the income of the members could be adequately determined without the need for a partnership calculation.[2]

However, the entity did need to elect in accordance with the requirements of Regulation §1.761-2. Note, though, that the "dumb but lucky" provision of Reg.

[1] "The provision is not intended to change the determination under present law of whether an entity is a partnership for Federal tax purposes (without regard to the election provided by the provision)."
[2] §761(a)

§1.761-2(b)(ii) can bail out such entities even if they were unaware of the need to make a formal election. The election is one that is binding on the entity until it either no longer qualifies or gets the permission of the IRS to revoke the election, permission that must be requested by the end of the first 30 days of the year during which the election is to apply.[3]

However, new §761(f) provides another way out of filing Form 1065, a method that can be used either in lieu of §761(a)'s out for entities that qualify for §761(a) treatment or by entities that fail to meet §761(a)'s requirements.

The IRS instructions to Form 1065 go on to describe this option. They provide:

> **Exception—Qualified joint venture.** Beginning in 2007, if you and your spouse materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make an election to be treated as a qualified joint venture instead of a partnership. By making the election, you will not be required to file Form 1065 for any year the election is in effect and will instead report the income and deductions directly on your joint return.
>
> To make this election, you must divide all items of income, gain, loss, deduction, and credit between you and your spouse in accordance with your respective interests in the venture. Each of you must file a separate Schedule C, C-EZ, or F. On each line of your separate Schedule C, C-EZ, or F, you must enter your share of the applicable income, deduction, or loss. Each of you also must file a separate Schedule SE to pay self-employment tax.

This answered one of the key questions—how do we make the election? The answer is simply by not filing a Form 1065 and simply reporting the amounts on Schedule C. In the January 8 online webcast from TaxTalkToday, Curt Freeman, IRS Branch Chief, Business Forms & Publications, specifically noted that no final Form 1065 would be filed for an entity that had previously filed Form 1065—and recognized that this would likely create issues with computer notices looking for the Form 1065.[4]

While the question of what represents each respective share isn't directly addressed, it would seem that same rules would apply that would have applied had a formal Form 1065 been prepared, with each spouse simply reporting "line item" income and expense rather than a single number for what would have

[3] Reg. §1.761-2(b)(3)(i)
[4] You can view the archived program at http://www.taxtalktoday.tv/index.cfm?page=8.773

represented nonseparately stated items of income and expense or the summary reports of separately stated items. Similarly, it would appear that the rest of Subchapter K's rules for recognizing the validity of allocations would also apply, as §761(f), unlike §761(a), doesn't remove the entity from Subchapter K's applicability by its terms.

But note that if previously you have reported this jointly owned entity not on a Form 1065, but rather on Schedule E, you may not be able to move into §761(f) treatment. Having elected out of Subchapter K, you can only get back in with IRS permission—and that permission had to be requested within the first 30 days of 2007 for Subchapter K (and therefore §761(f) under that subchapter) to apply. That would have required clairvoyance, since §761(f) didn't actually make it into the law until May, well after the date to ask in.

If you were using Revenue Ruling 2002-69 you don't have this problem. The ruling allows a taxpayer to have a deemed formation of a partnership each year, so it would appear the taxpayers could elect to not disregard the entity and then elect to apply the provisions of §761(f).

But, you may wonder, why would I care? After all, wouldn't treatment under §761(f) or Revenue Ruling 2002-69 really be the same as what I have now? Keep reading and you'll see the answer is, no, there really is a difference.

But Wait There's More…

The next paragraph in the IRS instructions is one that caused a number of readers to go back and reread what they saw—and certainly created a discussion on the TaxTalkToday webcast mentioned above. The Form 1065 instructions go on to note:

> If you and your spouse make the election for your rental real estate business, you each must report your share of income and deductions on Schedule C or C-EZ instead of Schedule E. Although rental real estate income generally is not included in net earnings from self-employment, you and your spouse each must take into account your share of the income and deductions from the rental real estate business in figuring your net earnings from self-employment on Schedule SE.

How did that one happen was the initial question many had—and the answer comes from looking more deeply at the law, including §8215(b) of the Act that initially got little coverage.

First, a quick review of self-employment tax before this change is in order. The basic rule for self-employment taxation is found at the beginning of §1402(a) which provides:

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

Rental activities are a "trade or business" activity generally (think about net operating losses—you can carry back NOLs based on rental losses), so how do they escape self-employment tax? Well that's because §1402(a)(1) gives an out. It provides an exclusion for:

> (1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;

So if we have a rental property in a partnership, despite the fact that §1402(a) would generally bring the partners' share of that activitys income/loss into self-employment income, §1402(a)(1) works to override the general rule. So why does it fail when §761(f) is involved? After all, even when property is held by an individual, that same §1402(a)(1) crops up to block the self-employment tax.

Well the answer lies in Act §8215(b), which added an exception to the exception. The new law added §1402(a)(17) which provides:

> (17) notwithstanding the preceding provisions of this subsection, each spouse's share of income or loss from a qualified joint venture shall be taken into account as provided in section 761(f) in

> determining net earnings from self-employment of such spouse.

So if we make the election, the income or loss from the rental goes against self-employment income. That may be good news or bad news depending on your situation or goal—but it is important to know this effect is there.

I Want Out Now

Clients may not mind the treatment in loss years, but what happens when they no longer want this treatment? Well, the IRS tells us in the instructions that, unlike Revenue Procedure 2002-69's treatment, we can't just decide we want out and file a Form 1065 next year. The instructions note:

> Once made, the election cannot be revoked without IRS consent. If you and your spouse filed a Form 1065 for the year prior to the election, you do not need to amend that return or file a final Form 1065 for the year the election takes effect. However, the partnership terminates at the end of the tax year immediately preceding the year the election takes effect.

It's also important to note that termination event that takes place in the immediately prior year. While that normally will be a tax non-event, it isn't necessarily so.

While we need permission to revoke the election, it would appear that if we no longer qualify to be a Qualified Joint Venture that the treatment would cease, much as S corporation status ends if the S corporation ends up with a corporate shareholder. Under the current law, it would appear that if, like with the S corporation, the taxpayers transferred any interest to a party other than themselves (such as gifting a 1% interest to a third party or to a corporation formed by one or both of the spouses), that would trigger a violation of §761(f)(2)(A) and would end the treatment as a qualified joint venture.

Before getting too "cute" with such a treatment, remember that the IRS retains the hammer of Reg. §1.701-2, where the IRS could argue that your transfer of a minimal interest to a disqualified entity violates the intent of Subchapter K, especially where that seems designed simply to avoid self-employment tax after years of reducing self-employment tax via losses passed through.

Planning

It's important to note that §761(f) elections have more consequences than you might have expected, and to consider both whether that argues against using this option or, in some cases, in favor of using it if you will have deductible losses from rental activities.

As well, in many cases you may have alternatives. For now, those in community property states will often have the option of using Revenue Procedure 2002-69 (which does not change self-employment tax treatment of rental income) or IRC §761(f). And, in many cases, a rental partnership would appear to qualify for election out of Subchapter K in its initial year under §761(a).

Clients need to be informed of the potential consequences (both positive and negative) of each choice.