

# TAX UPDATE

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Upon Further Review—Self-Employment Tax Issues  
March 24, 2008



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## Back to The Future

Back in early July 2005 I started experimenting with these podcasts, driven by the fact that Apple had added support for this distribution method to its iTunes Music Store. The second podcast I posted dealt with self-employment taxation and LLCs, based on a presentation I had given at the Phoenix Tax Workshop. I wanted to go back and do a more complete review of the issue, and bring the matter up to date.

As well, last month we dealt with self-employment tax and the new §761 qualified joint ventures based on a discussion in the January Tax Talk Today webcast/podcast and the Form 1065 instructions. In the most recent Tax Talk Today it was noted in passing that the matter was “clarified” in a revised transcript of that January program.

The clarification is found at

[http://lmpdg.net/ttt/docs/tr\\_Jan\\_08\\_CORRECTED\\_transcript.pdf](http://lmpdg.net/ttt/docs/tr_Jan_08_CORRECTED_transcript.pdf) .

The PDF that contains this clarification shows a revision date of March 7 in its file properties, so it appears this revelation came to the IRS just recently and, like many IRS clarifications, it really represents a reversal of position.

## **LLC Members and Self-Employment tax**

A major area of confusion exists among practitioners and clients on the proper treatment of LLC members where the self-employment tax is concerned. This confusion exists due to both the fact that when §1402(a)(13) was added to the Internal Revenue Code no such thing as a limited liability company existed (or would for a couple of more decades) and the fact that the IRS's 1997 proposed regulations to clarify this matter became very politically controversial, resulting in regulatory paralysis on the matter since those regulations were first proposed. In fact, to this date they remain in the limbo of proposed status.

### ***Partners and Self-Employment Tax***

Under §1402(a), generally every partner is subject to self-employment tax on their "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" regardless of the level of action (or inaction) on the part of the partner himself. That is, the test for the conduct of a trade or business is conducted at the partnership level.

An exception to this general rule exists at §1402(a)(13) for limited partners that provides "there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services."

Taxpayers who have attempted to argue that if they simply aren't active in the partnership they should be treated as exempt from self-employment tax have not fared well in court when it has gotten there. In the case of *Norwood v. Commissioner*, (TC Memo 2000-84) a taxpayer who did virtually no work in the partnership's business was still required to pay self-employment tax on his share of the partnership's business income. That was true even though the taxpayer's share of the trade or business income was treated as passive income under §469, nor did the fact that he had no participation or any level of control over the partnership's operations turn his interest into a limited partnership interest that would allow him to make use of §1402(a)(13)'s exception.

The court specifically noted, "the passive activity rules under section 469 have no application in this case." As well, more ominously for taxpayers who have ownerships interests in LLCs with operating businesses who hope to avoid liability for self-employment tax, the court bluntly stated, "a limited partnership

must be created in the form prescribed by State law.”

Limited liability companies are not limited partnerships under state partnership laws. For instance, in California limited partnerships are defined in Title 2 of the California Corporations Code (the general partnerships title), while limited liability companies are defined and established via Title 2.5 of the Corporations Code—that is, they are different things. However, an LLC treated as a partnership under check the box regulations is a partnership for all purposes under the IRC, so if it is not treated as a limited partnership for purposes of §1402(a)(13) then holders of interests in limited liability companies would appear fully exposed to self-employment tax liability on their share of the LLC’s trade or business income.

However, this regime was enacted to solve a very different problem than what we face today. This history was discussed by Burgess and William Raby in their article “Partners, LLC Members, And SE Tax” published in *Tax Practice* back in 2000 where they noted that “If the taxpayer was over 50 but not covered by social security, obtaining 40 quarters of coverage by becoming a limited partner was a way of obtaining fully insured status under the social security rules, and thus of purchasing social security benefits worth a great deal more than the modest self-employment tax that would have to be paid.”<sup>1</sup> While §1402(a)(13) shut down this loophole, the article points out it’s clear now that the loophole has been otherwise rendered moot by changes in social security rates and taxation and that the problem is not large numbers of taxpayers trying to pay self-employment tax.

### **1997 Proposed Regulations**

The result described above didn’t really sit well with many, including those at the IRS, resulting in two sets of proposed regulations. In 1994 they first broached the idea that maybe “limited partner” didn’t have to literally mean “limited partner” under state law, but rather someone who could have been a limited partner under state law (the 1994 proposed regulations).

The issue pulled those proposed regulations and in a move meant to integrate with the then recently created check the box regulations, submitted a new set of proposed regulations to attempt to update the view of self-employment taxation, again redefining what is a limited partner. The 1997 proposed regulations remain in that form to this date for reasons we’ll discuss later, but for now we’ll just look at how those rules propose to resolve the issue of self-employment taxation of limited liability company members.

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<sup>1</sup> Burgess J.W. Raby and William L. Raby “Partners, LLC Members, And SE Tax”, *Tax Practice*, May 8, 2000, p. 165 (26 Tax Prac. 165 (May 8, 2000))

### **Definition of a Limited Partner**

As with check the box's view of what was a partnership, the IRS proposed to junk the prior law views on the question of what was a limited partner for purposes of §1402(a)(13). Proposed Regulation §1.1402(a)-2(h) provided a general set of tests for who would be a limited partner for the purposes of §1402 only (that is, it wouldn't impact the analysis under §469 for passive activities).

First, a service partner in a service partnership could never be treated as a limited partner under these regulations, even if that person was recognized as a limited partner under the applicable state law [Proposed Regulation §1.1402(a)-2(h)(5)]. A service partnership is defined as "partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting," [Proposed Reg. §1.1402(a)-2(h)(6)(iii)] a definition not coincidentally similar to that for personal service corporations.

A service partner in that service partnership is defined as a partner that provides more than *de minimis* amounts of services to or on behalf of the service partnership's trade or business [Proposed Reg. §1.1402(a)-2(h)(6)(ii)].

Partners who cleared the service partner/partnership are presumed to be limited partners unless they fail one of three tests:

- The partner has personal liability to the creditors of the partnership by reason of being a partner;
- The partner has the authority under the laws of the jurisdiction where the partnership was formed to contract on behalf of the partnership *or*
- The partner participated in the partnership's trade or business for more than 500 hours during the partnership's tax year [Proposed Reg. §1.1402(a)-1(h)(2)]

A partner that fails only the last of those three tests can still be treated as a limited partner if two other hurdles are cleared. That individual will continue to be treated as a limited partner if:

- Limited partners who don't need this exception to qualify own a substantial, continuing interest in the specific class of partnership interests held by the 500 hour partner *and*
- The 500 hour partner's rights and obligations with regard to his interest is identical to these same other limited partners [Proposed Reg. §1.1402(a)-2(h)(4)]

The preamble to the proposed regulations make clear that this person can take guaranteed payments (which would be subject to self-employment tax) as a different right—that is, in the words of the preamble, the person can “bifurcate his or her distributive share by disregarding guaranteed payments for services” but only if there are other partners not having to bifurcate their interests who hold similar interests. The preamble claims this limits the exclusion from self-employment tax to amounts that “are demonstrably returns on capital invested in the partnership” presumably since the other non-active members are getting the same allocation of income, and their interest are more than nominal.

Holders of multiple interests that failed any or all of three tests (but are not service partners in a service partnership) also are granted the right to treat certain interests as not being subject to self-employment tax. To obtain this relief, the holder must show

- Limited partners who don't need this exception to qualify own a substantial, continuing interest in the specific class of partnership interests held by the 500 hour partner *and*
- The rights and obligations with regard to the extra interest(s) is/are identical to those same other limited partners [Proposed Reg. §1.1402(a)-2(h)(4)]

### **1997 Moratorium**

The fact that the proposed regulations ignored all prior law and, specifically, would create self-employment tax liability for a partner that could be recognized under the governing law of the state in question as a limited partner made these regulations controversial.

In the Taxpayer Relief Act of 1997, Congress reacted to these proposed regulations by including in the law §935 of the act that provided: “No temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.”

July 1, 1998 passed by and Congress did not extend the moratorium, nor did Congress modify the underlying law to clarify the treatment of limited partners and others for self-employment tax purposes. Similarly, the IRS has never either withdrawn the proposed regulations, replaced them with a modified version or taken the regulations to final status. As of the date this manual was written, the proposed regulations remain on the books as proposed regulations.

### **Later Developments**

In recent years, interest has picked up in the area of self-employment and FICA/Medicare taxation. A number of cases have arisen over the years on the

question of S corporation shareholders attempting to avoid FICA/Medicare liability by taking no or very low salaries in an S corporation setting, and then taking other income from their services as distributions from the S corporation. While the IRS has been relatively successful in the litigation arena, the perception is that far more S corporation shareholders are underpaying their share of payroll taxes.

That, along with the financial issues facing Social Security and Medicare programs, have turned interest on the whole area of FICA/Medicare taxation and self-employment taxes. The chair and ranking minority members of the Senate Finance Committee in 2006 asked the staff of the Joint Committee on Taxation to report on potential sources of revenue, and reform in the area of self-employment and FICA/Medicare taxation was a significant area they discussed.

The committee's proposals would, in some form, reduce or eliminate the limited partner exception to the imposition of self-employment taxes. Either all partnership and S corporation passthrough income related to a trade or business would be subjected to self-employment taxation, or income from service partnership or S corporations would be made subject to self-employment tax, with definitions very similar to those found in the 1997 proposed regulations.

While no action has been taken on the proposals in that report, they have been discussed a number of times in recent years as Congress has been looking for funding sources for new tax bills.

### ***Options for Reporting***

While the matter remains in flux, tax returns still need to be filed. In addition, the heightened standard for taking positions on tax returns for tax preparers factor into making this matter even more difficult for most preparers.

The IRS has informally indicated on numerous occasions that if a preparer excludes income from treatment as self-employment income for a partner that would have qualified for such exclusion under the proposed regulations, the IRS would not challenge that position. In the right cases, the proposed regulations could allow a practitioner to work with a client to insure that their interest in the LLC would qualify for partial or full exclusion from self-employment taxation.

If a taxpayer is legitimately a limited partner in a limited partnership formed under a state law limited partnership statute, it would appear that the case law cited earlier and the literal wording of §1402(a)(13) would clearly allow a preparer to exclude that partner's income from treatment as self-employment tax except to the extent of any true guaranteed payments received for services.

In other cases, the practitioner will need to consider the level of authority the practitioner believes exists for treating the amounts being received as either

subject to or not subject to self-employment taxation. There's been much discussion of locking the definition of "limited partner" based on the level of activity within the partnership and/or integrating the "reasonable compensation" theory that we look towards in the related S corporation/FICA arena to come up with an amount subject to self-employment tax. Many taxpayers make use of such options in reporting self-employment income, and right now the IRS does appear apt to challenge anything arguably reasonable. Unfortunately, though, there's little authority supporting these positions aside from the argument that the existence of the 1994 and 1997 proposed regulations indicates the IRS claims the definition of what is a limited partner is flexible under the statute.

Consideration may need to be given to the necessity to meet the disclosure requirements of §6694 if the practitioner believes there is a reasonable basis for excluding the item from self-employment income based on a view of what is truly the limited partnership interest, but cannot get comfort (especially in light of the *Norwood* rationale) that the chances are more likely than not that a judge in possession of all facts would rule the law did not treat the payment as self-employment income.

As well, given the uncertainty in this area, tax practitioners to make sure they clearly explain to their clients the options the practitioner views as having varying levels of support, the disclosure issues that may be raised, and the exposure each position opens up. We must always remember it is the taxpayer's choice to make whether or not he/she takes a position on the return, but we also need to be clear that we are not guaranteeing results in an area where, frankly, no guarantees really can be offered.

## And About Those Qualified Joint Ventures

Back on February 17, I discussed the issue of self-employment taxes, real estate and qualified joint ventures. The issue revolved around the following addition to IRC §1402(a) defining self-employment income:

(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.

The January Tax Talk Today webcast/podcast ([www.taxtalktoday.tv](http://www.taxtalktoday.tv)) presented by the IRS discussed this provision. The discussion arose as practitioners noted the following interpretation of this provision as applied to rental real estate found on page 2 of the 2007 Form 1065 instructions:

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.

In the original program a viewer asked for clarification, which was provided as follows per the transcript:

Yeah, I'm not surprised somebody wanted a clarification because that's a strange twist to it, but that is actually what the law says. It says that they will compile it with their 1040. If [EKZ note-I believe the actual word used was "with", though the transcript says "if"] that election, what would be not subject to SE tax flowing through a 1065 is subject to SE tax on the two Schedule C's.

In this month's Tax Talk Today presentation on International Tax Matters, a reference is made at the beginning of the program to the need to check for an updated transcript for a "clarification" of the issue.

On page 19 of the revised January transcript, we find the following clarification:

While the profit (or loss) from a real estate rental trade or business operated by a husband and wife will be reported on two Schedule Cs if the spouses make a qualified joint venture (QJV) election, neither making the QJV election nor reporting the profit (or loss) on two Schedules C converts amounts which are statutorily excluded from Self-Employment Contributions Act (SECA) tax into amounts subject to SECA tax. Similarly, simply electing to be treated as a QJV, and thereby reporting the real estate joint venture profit (or loss) on two Schedule Cs, does not convert the income or loss from passive to non-passive.

Or, it seems to be, forget what we said in the Form 1065 instructions.

As of the date I am writing this (March 20, 2008), the IRS instructions for Form 1065 still contain the statement noted above. As we know, IRS instructions are no authoritative, but then again neither are transcript corrections posted on IRS related websites.

So what is the proper treatment for self-employment income for these items? We have to speculate on why the IRS decided to put that clarification up, but I wouldn't be surprised to find that the IRS got concerned that since many rentals throw off losses, a husband-wife QJV for rental real estate could have presented

a real opportunity for reducing self-employment tax for the self-employed.

But that still raises the question about exactly §1402(a)(17) is meant to apply to. The “new” IRS view would apparently see this provision as simply saying we use the partnership rules (where we look at whether the partnership conducted a trade or business) rather than individual rules (where the individual has to conduct a trade or business) under the initial clause in §1402(a), and it does not mean that §1402(a)(1) is ignored. Whether that’s how the provision should be viewed isn’t clear from its language—at least to this author, the “clarified” view seems to involve a more strained reading of the provision than the view in the instructions, though the provision isn’t very clear on exactly what it really means.

On passive activity rules, the clarification is on stronger ground—and it doesn’t appear to contradict anything said in either the instructions to Form 1065 nor the webcast/podcast. §1402(a)(17) is clearly limited in application to SECA issues, and would not impact §469 issues.

What this does illustrate is that depending on “unofficial” IRS sources is always risky—even unofficial ones that look official, like the IRS instructions. As the Tax Court likes to recite, the instructions and publications are not binding rulings on the law—if the law is different, the law carries the day. When we look at positions under the rules of §6694, we have to remember that we need to look at binding sources.

And, of course, that also means that the above warning about IRS public representations on the use of the proposed regulations noted above for LLC self-employment taxation where the proposed regulations were never issued with a “taxpayers may rely” provision would apparently be subject to a similar “clarification” at a later date. So, *caveat emptor*...