

TAX UPDATE

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Qualified Joint Venture and Memo on Self-Employment Tax April 22, 2008



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IRS Gives Analysis on Self-Employment Tax and Qualified Joint Venture

We've covered this topic before, both the original discussion of the point on the IRS's Tax Talk Today webcast/podcast and the "correction" that came up in the following presentation of that program. Now the IRS has released a legal memorandum that outlines the "new improved" IRS position on this matter.

To review, the key question is whether a married couple that elects to have their rental property treated as a qualified joint venture under §761(f), does that convert the rental property's income into self-employment income—and, perhaps, also convert rental losses into amounts that would offset self-employment income. The instructions to Form 1065 and the IRS discussion in the January Tax Talk Today indicated the answer was yes—but the IRS later issued a modified version of the transcript of that presentation and specifically referred to that modified transcript in the following Tax Talk Today.

The Law

IRC §761(f) was added to the law last year to allow married taxpayers in some cases to not be required to file a Form 1065, but rather be able to report their joint income from their venture on the Form 1040 itself. The section provides:

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| <p>(f) Qualified joint venture</p> <p>(1) In general</p> <p>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--</p> <p>(A) such joint venture shall not be treated as a partnership,</p> <p>(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</p> <p>(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.</p> <p>(2) Qualified joint venture</p> <p>For purposes of paragraph (1), the term "qualified joint venture" means any joint venture involving the conduct of a trade or business if--</p> <p>(A) the only members of such joint venture are a husband and wife,</p> <p>(B) both spouses materially participate (within the meaning of section 469(h) without regard to paragraph (5) thereof) in such trade or business, and</p> <p>(C) both spouses elect the application of this subsection.</p> |
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As well, another provision was added to §1402 which is the cause of the controversy in question. That provision at §1402(a)(17) provides:

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| <p>(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</p> |
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determining net earnings from self-employment of such spouse.

The question that we end up having to resolve is this—what, exactly, did Congress mean by the phrase *notwithstanding the preceding provisions of this subsection* in that provision—does it solely refer to how allocate items of income that otherwise are determined to be self-employment income, or does it serve to effectively repeal the exceptions to the inclusion in self-employment income found elsewhere in §1402(a)?

The Form 1065 Instructions

The initial view of the IRS, as expressed in the instructions to Form 1065 (which, as we know, is a wholly unofficial expression of position that is not binding on the IRS), was that this new provision did remove the exceptions found in §1402(a)—or at least the one dealing with rental real estate income. The relevant provision, found in column 2 on page 2 of the instructions, provided:

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.

Those instructions remain the ones posted on the IRS's website for Form 1065.

On the Tax Talk Today show there was the following exchange per the transcript between Curt Freeman of the IRS and Elizabeth Buckingham, an enrolled agent with Murray Wells Wendeln & Robinson CPAs in Dayton, Ohio:

“Can you clarify the application of self-employment tax to rental real estate activities by husband-wife venture? Will SE, will self-employed tax apply?” Again.

MR. FREEMAN: 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 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.

MS. BUCKINGHAM: But it's interesting. As you said that, I was thinking about that's good if they have other Schedule C income, other self-employment income.

MR. FREEMAN: Yeah, they're –

MS. BUCKINGHAM: They could use it as a reduction.

MR. FREEMAN: Right.

MS. BUCKINGHAM: Because generally, you're right. Rental real estate is usually a lot.

I believe the last word in that transcript is wrong—what she actually said (and what makes a lot more sense) is a “a loss,” referring to the fact that rentals tend to throw off losses.

On the same page as that original exchange, in a revised transcript the IRS posted the following “clarification” (which actually is pure and simple a total reversal of what was said in the transcript):

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.

As I noted when I first posted about this change, the date on the transcript file indicates it was posted in the first week of March.

IRS Gets More Formal in the Analysis

This week the IRS made public a Chief Counsel Advice that was dated March 18th that more formally outlines the support for that position. Note that what we have still is not a “binding” document for those of us outside the IRS on this matter¹, but it appears likely that the IRS plans to hold to this position at this point, at least unless Congress clarifies the section to make it clear they meant it to be handled the other way.

More likely, I suspect, is that Congress will clarify §1402(a)(17) to clearly reflect this ruling since it was the Form 1065 instructions that surprised many of us. That reading, while I believe is the “less tortured” way to read the actual text of

¹ The CCA, like all such documents, starts out right away stating “This advice may not be used or cited as precedent.”

the IRC, has consequences far beyond what it is likely Congress intended (as the author of the CCA also believed).

The Chief Counsel Advice

The CCA in question seeks to respond to questions that arose regarding this provision from the Small Business/Self-Employed division. For the most part I'm going to quote from the CCA to outline the position, since I believe the CCA itself does a good job of explaining this position—but we'll talk about why there is the other way to read the provision.

The issue, as stated by the CCA, is the following:

Does a husband and wife's election of qualified joint venture status ("QJV") pursuant to I.R.C. section 761(f) for a rental real estate business convert the income derived from the business into net earnings from self-employment ("NESE") when the income otherwise would be excluded from NESE under section 1402(a)?

The CCA immediately gives its conclusion:

No, if the income is otherwise excludable from NESE under section 1402(a), election of QJV status does not convert such income into NESE.

The CCA then goes on to give the background giving rise to the controversy. It starts out with the general explanation of §761(f) itself:

Section 761(f) provides that a qualified joint venture shall not be treated as a partnership for federal tax purposes. Thus a husband and wife who elect QJV status do not need to file a partnership income tax return. Rather, they are treated as maintaining two sole proprietorships for all federal tax purposes, including income tax and self-employment tax, and are required to file tax returns accordingly.

The next key point outlined are the IRS instructions to taxpayers about how to deal with this QJV entity when preparing their tax returns. The CCA outlines certain instructions, though significantly doesn't discuss the Form 1065 instructions noted above, I suspect because it's going to be impossible to mention those without having to "go on the record" that the instructions are in error—something that I don't think the IRS would like to highlight:

The IRS has communicated to taxpayers that when a husband and wife elect QJV status, each spouse must file with their joint income tax return a separate Schedule C (Form 1040), Profit or

Loss From Business (Sole Proprietorship) or Schedule F (Form 1040), Profit of Loss From Farming, and a separate Schedule SE (Form 1040), Self-Employment Tax, as applicable. See the article on the IRS website at www.irs.gov, keyword "qualified joint venture." While the general instructions for the 2007 Form 1040 do not address the reporting of rental real estate income that would otherwise be reported on Schedule E (Form 1040), Supplemental Income and Loss, for those making a QJV election, the instructions for the 2007 Schedule E have informed taxpayers who make the QJV election for a rental real estate business that each spouse must report his or her share of such income on their respective Schedules C and not on Schedules E.

The CCA goes on to note that the IRS has received a number of inquiries about whether such income will be subject to self-employment tax (we know that at least Ms. Buckingham, EA of Dayton has asked about this matter and, like many of us, were a bit surprised by the initial conclusion).

The CCA analyzes initially the reasons for qualified joint venture reporting, and the reason why Congress stated for needing to also modify the self-employment tax provision:

The Act added section 761(f) to the Code which provides that a QJV shall not be treated as a partnership for federal tax purposes. A QJV is a joint venture that conducts a trade or business¹ where: (1) the only members of the joint venture are a husband and wife who file a joint return, (2) both spouses materially participate in the trade or business, and (3) both spouses elect not to be treated as a partnership. I.R.C. section 761(f)(2). For this purpose, "material participation" has the same meaning as under the passive activity loss rules in section 469(h) and the corresponding regulations. *Id.*² The spouses must divide the items of income, gain, loss, deduction, and credit in accordance with their respective interests in the venture, and each spouse takes into account each item as if it were attributable to him or her as a sole proprietor. I.R.C. section 761(f)(1)(B) and (C).

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¹ Note that a husband and wife must be conducting a trade or business; mere joint ownership of property does not qualify for the election.

² Note that, except as provided in section 469(c)(7), rental real estate income or loss generally is treated as passive income or

loss under section 469. The presence of "material participation" does not change the passive character. Accordingly, the spouses' QJV election, premised on the spouses' material participation, does not alter the character of passive income or loss.

The CCA then goes on to review the general definition of self-employment income found in §1402(a) prior to the revision in question:

Generally, the Code imposes a tax upon an individual's self-employment income, defined as net earnings from self-employment ("NESE") with certain adjustments. I.R.C. sections 1401 and 1402(b). The Code defines NESE generally as gross income derived by an individual from a trade or business, plus the distributive share of income or loss from a partnership of which the individual is a member. The Code enumerates many exceptions to this general definition. I.R.C. section 1402(a). One such exception excludes rental income from real estate from the definition of NESE, unless such rental income is received in the course of a trade or business as a real estate dealer.³ I.R.C. section 1402(a)(1). Other provisions generally exclude dividend income and gain or loss from sale or exchange of a capital asset. See I.R.C. sections 1402(a)(2) and (3).

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³ However, income from renting farm property is included in NESE and is subject to SECA tax if the income is derived by a contract between the owner or tenant of the land and another individual to produce agricultural or horticultural commodities, such contract provides that the owner or tenant of the land will materially participate in the production of the commodity, and such person does so materially participate. See I.R.C. section 1402(a)(1).

The CCA then goes on to look at the new §1402(a)(17) provision we noted above and looks at the author's view of the legislative history behind the provision:

The relevant legislative history makes clear that NESE is determined by taking into account each spouse's respective share of the business from the QJV, just as for federal income tax purposes. See H.R. Rep. No. 110-14, at 14?16 (2007) ("Report"). The Report indicates that the reason for the change is to reduce complexity for business ventures run by a husband and wife filing a joint return by eliminating the need to file a partnership income tax return because the "reported income would be the same on a joint return, whether or not a partnership return is filed." *Id.* at 15.

The Report also expresses Congress' concern that, in some cases, only one spouse reports the net earnings from self-employment from the venture, with the result that only one spouse receives credit for social security benefit purposes. *Id.* at 15.

Congress intended each spouse to account for his or her respective share of the QJV income as a sole proprietor, "anticipat[ing] that each spouse would account for his or her respective share on the appropriate form, such as a Schedule C." *Id.* at 16. Additionally, in explaining its reasons for the change, Congress expressed its expectation that "both spouses, not just one, should be treated as having net earnings from self-employment from the venture in accordance with their respective interests." *Id.* at 15. *Taken together, the legislative history suggests that any income earned by a QJV is reported for all federal tax purposes using the same forms as if each spouse were a sole proprietor who earns such income.*

The CCA notes that, generally, a person who has rental real estate income would report that income on Schedule E and not count it as self-employment income.

Having set up the background, the CCA now goes on to give what the author views as the proper application of this provision:

The specific language of section 1402(a)(17) provides that each spouse's share of the QJV income shall be taken into account in determining the NESE of each spouse. The reference back to section 761(f) prescribes how the total income of the QJV is to be divided between the spouses. The phrase "notwithstanding the preceding provisions of this subsection," read in context with the rest of section 1402 and the legislative history discussed above, directs that none of the preceding subsections is to alter that allocation between spouses. *To read the phrase "notwithstanding the preceding provisions of this subsection" as nullifying the application of all the exclusions from NESE would trigger dramatic changes in the application of self-employment tax to spouses electing QJV. Not only rental real estate income from a QJV, but also dividends and capital gains, would become subject to self-employment tax if earned by a QJV. We find no indication in the statute or legislative history that Congress intended the "notwithstanding" phrase to be read in that way. The purpose of section 761(f) was to eliminate a reporting burden, specifically the filing of a partnership income tax return in addition to the spouses' joint income tax return, while ensuring that both participating spouses, rather than just one spouse, may receive social security*

credit for their net earnings from self-employment. The purpose of section 761(f) was not to convert income that would otherwise be excluded from NESE altogether into income that is subject to self-employment tax.

Thus, the amounts are ruled not to be subject to self-employment tax by virtue of §1402(a)(1)'s exclusion for such rental income.

About Those Notices Our Computers Are Going to Be Sending Out.

In the section titled “Case Developments, Hazards and Other Considerations” we find that the author realizes there’s a bit of problem with how the IRS computer system is going to view what the author views to be a properly prepared return. That is, the IRS computer is going to be looking for a Schedule SE when it sees a Schedule C—and that would give rise to notices if the rental showed income sufficient to trigger a self-employment tax liability if, in fact, the amounts had been self-employment income.

The author gives the following advice, albeit not terribly reassuring to anyone who prepared a return showing rental income from a qualified joint venture:

We understand that following the instruction to those making a QJV election to report rental real estate income from a QJV on Schedules C rather than Schedules E may prompt IRS inquiries when a taxpayer files a Form 1040 with Schedules C attached but no corresponding Schedules SE. We recommend that the appropriate Service Center functions be alerted to this issue so that the appropriate actions can be taken to ensure the self-employment tax provisions are applied correctly.

This “Other Consideration” is that a taxpayer is going to get a letter, and hopefully the person dealing with the correspondence will have gotten word that any assessment of self-employment tax is in error.

Do They Have It Right in This CCA?

Well, maybe—and from a practical standpoint, they may retroactively get an endorsement from Congress, as this seems ripe for a clarification in a technical correction. That said, I certainly can see how the original conclusion, stated in the transcript of the Tax Talk Today program, was arrived at. Note that the IRS employee in that case certainly read the legislative history completely differently from the way it ended up being read in the CCA.

However, I suspect the pointed question about the use of losses in that IRS

sponsored program may very well have lead to the reaction that got this new guidance issued and the “correction” added to the transcript of that program. If the original position had stood up, then taxpayers with rental losses could have used those losses to offset other self-employment income had they formed a qualified joint venture with their spouse to handle the rental real estate venture.

That said, it’s also important to note that even if the earlier reading is correct, you would still have to show material participation by both spouses in order to be able to use the QJV status—and that might not be terribly easy in a number of instances, especially if the rental itself didn’t require a lot of work to begin with.

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: March 18, 2008

to: Mary Gorman
Asst. Division Counsel (Prefiling)
(Small Business/Self-Employed)

from: Janine Cook
Branch Chief, Employment Tax Branch 1 (Exempt Organizations/Employment
Tax/Government Entities)
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subject: Qualified Joint Ventures and Rental Business Income

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Does a husband and wife's election of qualified joint venture status ("QJV") pursuant to I.R.C. section 761(f) for a rental real estate business convert the income derived from the business into net earnings from self-employment ("NESE") when the income otherwise would be excluded from NESE under section 1402(a)?

CONCLUSION

No, if the income is otherwise excludable from NESE under section 1402(a), election of QJV status does not convert such income into NESE.

BACKGROUND

On May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 ("Act"), P.L. 110-28, amended the Internal Revenue Code ("Code") to add section 761(f) to the Code. Section 761(f) provides special rules for a "qualified joint venture" ("QJV"), effective for taxable years beginning after December 31, 2006. Section 761(f) provides

that a qualified joint venture shall not be treated as a partnership for federal tax purposes. Thus a husband and wife who elect QJV status do not need to file a partnership income tax return. Rather, they are treated as maintaining two sole proprietorships for all federal tax purposes, including income tax and self-employment tax, and are required to file tax returns accordingly.

The IRS has communicated to taxpayers that when a husband and wife elect QJV status, each spouse must file with their joint income tax return a separate Schedule C (Form 1040), *Profit or Loss From Business (Sole Proprietorship)* or Schedule F (Form 1040), *Profit of Loss From Farming*, and a separate Schedule SE (Form 1040), *Self-Employment Tax*, as applicable. See the article on the IRS website at www.irs.gov, keyword “qualified joint venture.” While the general instructions for the 2007 Form 1040 do not address the reporting of rental real estate income that would otherwise be reported on Schedule E (Form 1040), *Supplemental Income and Loss*, for those making a QJV election, the instructions for the 2007 Schedule E have informed taxpayers who make the QJV election for a rental real estate business that each spouse must report his or her share of such income on their respective Schedules C and not on Schedules E.

We understand that various IRS and Counsel offices have received questions asking whether the QJV election results in the imposition of self-employment tax on income from a rental real estate business that would otherwise not be subject to self-employment tax.

LAW AND ANALYSIS

The Act added section 761(f) to the Code which provides that a QJV shall not be treated as a partnership for federal tax purposes. A QJV is a joint venture that conducts a trade or business¹ where: (1) the only members of the joint venture are a husband and wife who file a joint return, (2) both spouses materially participate in the trade or business, and (3) both spouses elect not to be treated as a partnership. I.R.C. section 761(f)(2). For this purpose, “material participation” has the same meaning as under the passive activity loss rules in section 469(h) and the corresponding regulations. *Id.*² The spouses must divide the items of income, gain, loss, deduction, and credit in accordance with their respective interests in the venture, and each spouse takes into account each item as if it were attributable to him or her as a sole proprietor. I.R.C. section 761(f)(1)(B) and (C).

¹ Note that a husband and wife must be conducting a trade or business; mere joint ownership of property does not qualify for the election.

² Note that, except as provided in section 469(c)(7), rental real estate income or loss generally is treated as passive income or loss under section 469. The presence of “material participation” does not change the passive character. Accordingly, the spouses’ QJV election, premised on the spouses’ material participation, does not alter the character of passive income or loss.

Generally, the Code imposes a tax upon an individual's self-employment income, defined as net earnings from self-employment ("NESE") with certain adjustments. I.R.C. sections 1401 and 1402(b). The Code defines NESE generally as gross income derived by an individual from a trade or business, plus the distributive share of income or loss from a partnership of which the individual is a member. The Code enumerates many exceptions to this general definition. I.R.C. section 1402(a). One such exception excludes rental income from real estate from the definition of NESE, unless such rental income is received in the course of a trade or business as a real estate dealer.³ I.R.C. section 1402(a)(1). Other provisions generally exclude dividend income and gain or loss from sale or exchange of a capital asset. See I.R.C. sections 1402(a)(2) and (3).

The Act further amended the definition of NESE by adding new section 1402(a)(17). New section 1402(a)(17) states:

"[N]otwithstanding the preceding provisions of this subsection, each spouse's share of income or loss from a [QJV] shall be taken into account as provided in section 761(f) in determining [NESE] of such spouse."

The relevant legislative history makes clear that NESE is determined by taking into account each spouse's respective share of the business from the QJV, just as for federal income tax purposes. See H.R. Rep. No. 110-14, at 14–16 (2007) ("Report"). The Report indicates that the reason for the change is to reduce complexity for business ventures run by a husband and wife filing a joint return by eliminating the need to file a partnership income tax return because the "reported income would be the same on a joint return, whether or not a partnership return is filed." *Id.* at 15. The Report also expresses Congress' concern that, in some cases, only one spouse reports the net earnings from self-employment from the venture, with the result that only one spouse receives credit for social security benefit purposes. *Id.* at 15.

Congress intended each spouse to account for his or her respective share of the QJV income as a sole proprietor, "anticipat[ing] that each spouse would account for his or her respective share on the appropriate form, such as a Schedule C." *Id.* at 16. Additionally, in explaining its reasons for the change, Congress expressed its expectation that "both spouses, not just one, should be treated as having net earnings from self-employment from the venture in accordance with their respective interests." *Id.* at 15. Taken together, the legislative history suggests that any income earned by a QJV is reported for all federal tax purposes using the same forms as if each spouse were a sole proprietor who earns such income.

³ However, income from renting farm property is included in NESE and is subject to SECA tax if the income is derived by a contract between the owner or tenant of the land and another individual to produce agricultural or horticultural commodities, such contract provides that the owner or tenant of the land will materially participate in the production of the commodity, and such person does so materially participate. See I.R.C. section 1402(a)(1).

Generally, an individual who has income from a rental real estate business would not be subject to self-employment tax on such income because it is excluded from NESE. I.R.C. section 1402(a)(1). The individual would report such income on a Schedule E (Form 1040). Amounts on the Schedule E are carried over to the individual's appropriate income tax return (usually a Form 1040, *U.S. Individual Income Tax Return*), but are not included on Schedule SE (Form 1040) in calculating self-employment tax.

The specific language of section 1402(a)(17) provides that each spouse's share of the QJV income shall be taken into account in determining the NESE of each spouse. The reference back to section 761(f) prescribes how the total income of the QJV is to be divided between the spouses. The phrase "notwithstanding the preceding provisions of this subsection," read in context with the rest of section 1402 and the legislative history discussed above, directs that none of the preceding subsections is to alter that allocation between spouses. To read the phrase "notwithstanding the preceding provisions of this subsection" as nullifying the application of all the exclusions from NESE would trigger dramatic changes in the application of self-employment tax to spouses electing QJV. Not only rental real estate income from a QJV, but also dividends and capital gains, would become subject to self-employment tax if earned by a QJV. We find no indication in the statute or legislative history that Congress intended the "notwithstanding" phrase to be read in that way. The purpose of section 761(f) was to eliminate a reporting burden, specifically the filing of a partnership income tax return in addition to the spouses' joint income tax return, while ensuring that both participating spouses, rather than just one spouse, may receive social security credit for their net earnings from self-employment. The purpose of section 761(f) was not to convert income that would otherwise be excluded from NESE altogether into income that is subject to self-employment tax.

As stated above, a sole proprietor with non-farm rental real estate income would not pay self-employment tax on such income unless it is received in the trade or business of a real estate dealer. Accordingly, in the case of a husband and wife who make the QJV election for a rental real estate business, each spouse has a share of the QJV income, and each spouse may exclude his or her respective share of the QJV income from NESE pursuant to the exclusion provided by section 1402(a)(1).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand that following the instruction to those making a QJV election to report rental real estate income from a QJV on Schedules C rather than Schedules E may prompt IRS inquiries when a taxpayer files a Form 1040 with Schedules C attached but no corresponding Schedules SE. We recommend that the appropriate Service Center functions be alerted to this issue so that the appropriate actions can be taken to ensure the self-employment tax provisions are applied correctly.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call me or _____ of my office at _____ if you have any further questions.