FICA and Self-Employment Tax Developments
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The whole area of FICA taxes and the closely related self-employment tax has become an area of increased political and IRS interest over the past few years. From the "stealth tax" regulations to amount of salary vice-presidential candidate John Edwards took from his S corporation law practice to the question of funding the President's social security reform proposals, this area has generated a lot of activity in the past few years.

Unlike when social security first came into being, and when many of the Code provisions and regulations were written, today most clients prefer to avoid as much as possible paying into social security, feeling that it's not a "good deal" for them given the amount of earned income subjected to the full tax and the taxation of benefits when social security begins paying out. Generally we find the bias in today's disputes in this area revolved around taxpayers who have asserted they are not subject to the tax and a tax collector who feels their income was subject to that tax.

Today's presentation will deal with the general background of FICA and self-employment taxes, look at the impact of choice of business entity on FICA and self-employment tax liability, consider two new Revenue Rulings by the IRS that expand FICA taxation into areas the IRS had previously ruled it did not apply to, and finally consider the conflicting court cases on the taxation of payments for tenure rights granted to teachers and professors taking early retirement.

Definition of Income Subject to FICA and Self-Employment Tax

Though we often treat these two taxes as if they were the same thing, in fact they are governed by widely separated Code sections that define certain types of income as being subject to each tax.

FICA is imposed on most wages as they are defined at §3121. The general rule is stated at the beginning of §3121(a) which provides that wages are "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash..." §3121(a) then goes on to list a number of items that are excluded from the definition of wages for FICA taxation purposes, then concludes by noting "nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from 'wages' as used in such chapter shall be construed to require a similar exclusion from 'wages' in the regulations prescribed for purposes of this chapter..."

§3121(b) rather broadly defines the term employment, again with a number of exceptions following the broad general rule.

Self-employment tax is applied on net earnings from self-employment, a term which is defined in §1402. The original broad definition is found at the beginning of §1402 and states "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...” again followed by a number of exceptions (such as for rental income or dividends).[1]

In this case, there are two very important exceptions. Generally, an employee is considering to be involved in carrying on a trade or business—so, in order to keep employees from paying self-employment tax on wages that generally would be subject to FICA, the term “trade or business” is limited by §1402(c)(2) to exclude most employment.

As well, since the default is that all partnership income derived from a trade or business not otherwise excluded is counted, the Code provides at §1402(a)(13) that “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 service.” This particular provision has been subject to a bit of controversy in recent years with the check the box regulations and limited liability companies that we’ll consider later.

If income falls outside these definitions, it’s not subject to either tax. So the key question to be decided in a real world situation is whether the income in question meets one or the other of these definitions.

S Corporations and FICA Taxes

One of the items that is missing from either list of included income is passthrough income received from an S corporation.[2] Some have used this quirk to attempt to use an S corporation to eliminate or greatly reduce amounts subject to FICA or self-employment taxation.

The IRS position in this matter is summarized in Revenue Ruling 74-44, where it holds that payments received from the S corporation as dividends in lieu of payments of reasonable compensation to owners performing services for the corporation are wages, subject to FICA and FUTA taxation. And the IRS has successfully defended this position in court, at least in extreme cases where no salary was paid, but virtually all income was paid out as distributions. See *Spicer Accounting, Inc. v US*, CA-9, 91-1 USTC ¶50,103, 918 F2d 90, and *J. Radtke v US*, DC Wis., 89-2 USTC ¶9466, 712 FSupp 143, aff’d, per curiam, CA-7, 90-1 USTC ¶50,113, 895 F2d 1196.

The IRS does face a bit of a conflict in pushing these cases too far, since the IRS also litigates excessive compensation cases against C corporation officers, where it is in the

1 One of the great urban legends in tax practice is that the level of activity determines if a partner generally is subject to self-employment tax—the theory goes that if I am essentially a passive investor as a partner, I’m not subject to self-employment tax. Unfortunately, the law has no such provision in it. This was explained in detail to the unfortunate taxpayer in *Norwood v. Commissioner* (T.C. Memo 2000-84).

2 It should be noted that it appears you could argue that §1366(b) renders that position subject to challenge, since that provision essentially says we put the shareholder “in the shoes” of the corporation as if the taxpayer had directly received the income, a view that could be expanded to enable a self-employment test. However, the IRS has never taken that position, though there has recently been some suggestion that the IRS could “solve” the S corporation self-employment tax “problem” by regulation—meaning, essentially, using §1366(b) to allow a “look through” to impose a self-employment tax. So far the IRS has not made such a proposal.

government's interests for income tax reasons to have the opposite result, especially before the dividend rate went to 15%.

That tension likely explains why the case of S corporation income escaping FICA and self-employment taxation that got the most coverage in the popular press was not the subject of any IRS action. During the 2004 Presidential campaign, it was disclosed that vice-presidential candidate John Edwards had, back when he was in law practice, taken a salary of $360,000 from his practice in 1998. And, by the way, had received an additional $5 million in passthrough income from the corporation (John had a very successful year in his practice).

While that situation created a stir in the press, the basic structure appears to have been in line with what has to be done to successfully use the S corporation structure to avoid tax—generally Medicare tax. The IRS arguably doesn't want to go to court and argue that a proper salary would have been $5,360,000—even in a profession service corporation context, a win in a case like that could cause the IRS problems with certain C corporation cases (after all, John did have other employees and the IRS has argued reasonable compensation in C corporation professional corporation cases in the past).

That said, these cases are always facts and circumstances cases. The taxpayer must be ready to demonstrate that, as required by Revenue Ruling 74-44, if they received any payments they are claiming aren't subject to FICA (they are passthrough of income) the shareholder must have been adequately compensated for those services that were performed.

In a "damage control" context, some practitioners who have taken over such clients after the fact have resorted to treating a certain amount of the distribution as being nonemployee compensation subject to self-employment tax.

Such a resolution is not without its risks—as noted in the beginning, these two taxes are separate from each other, and while we would hope the IRS would take a "no harm, no foul" position on such cases, it's theoretically possible the IRS could assess the FICA tax against the corporation after the statute had closed on a claim for refund on the self-employment tax if the corporation had not filed any payroll tax reports in the year in question. The major problem is that §3121(d)(1) provides that an employee includes any corporate officer.

That fact pattern is often found in one owner S corporations with no other employees who were advised by a "professional" to use the S corporation to avoid FICA or who "did their own research on the Internet" on this matter. In those cases, there's often significant resistance to file late Form 941s, since they are going to be subject to penalties for late payment of tax and late filing. Practitioners may need to consider their own exposure if they are associated with such a return and, at a minimum, want to be sure they have advised the client of the risks associated with such a position and that they make clear that the client could be subject to penalties and the possibility of paying the same tax twice if they go this route.[3]

3 Practitioners also need to consider whether they can be associated with a return that takes such a position, since there does not appear to be any legal theory under which this reporting is correct. And, after the new written advice rules go into effect on June 20, practitioners would need to be very careful about any written document where they appear to suggest or endorse this solution. As a practical matter, it most likely works—but the problem is that the taxpayer and practitioner are fully exposed without many defenses if the IRS decides not to take the "no harm, no foul" position.

Limited Liability Companies[4]

Limited liability companies (LLCs) have gone from a strange idea originated in Wyoming that had uncertain tax effects to one of the most popular structures used for new business entities, especially those operating in states, like Arizona, where no entity level tax is imposed. Their popularity soared when the "check the box" regulations became effective in January 1997.

LLCs do not exist as an entity under the Internal Revenue Code. In the IRC world view, a for profit entity can be an individual, partnership, trust, or corporation, and all entities must be shoved into one of those slots. An LLC legally has attributes of a corporation, a limited partnership and a general partnership (if it has multiple members). Check the box allowed taxpayers to "elect" to treat a multiple member LLC as either a partnership or a corporation, with the default treatment being a partnership.

That's all fine and good, but under §1402 we have two classifications of partnerships —limited partnerships (with very little exposure to self-employment tax per §1402(a)(13)) and all other partnerships (for which all trade or business income is subject to self-employment tax). Clearly merely telling us the LLC is a partnership isn't enough to solve the issue of what the self-employment tax result is (or at least maybe it isn't).

The IRS has wrestled with the issue over the years with two sets of proposed regulations, one set issued in 1994 and another rolled out in 1997 as a complement to the check the box rules (it actually was apparent to the IRS that check the box created an issue with LLCs). The 1997 rules proposed an activity level test for getting limited partner treatment under §1402(a)(13), and treated limited partnerships and LLCs in the same fashion. However, those regulations also excluded most professional businesses from using Section 1402(a)(13), even if organized as a true limited partnership.

These became known as the infamous "stealth tax" regulations. Congress stepped in and forbade the IRS from implementing these regulations prior to July 1, 1998, and made it pretty clear that Congress wasn't likely to let the IRS implement them at all. The IRS has had no stomach to revisit this issue, and Congress has been silent on the matter as well. So we have been left with the problem of how to deal with the ambiguity that check the box creates on LLCs.

The vacuum for guidance that has followed the Congressional action back in 1997 has created much confusion over the tax status of LLC members for self-employment tax purposes, and quite a few varying reporting positions by taxpayers. Many of these positions are derived from the two sets of proposed regulations. As well, some have argued for a literal reading of the statutory language.

1994 Proposed Regulations. Although they never became final, the theory of the 1994 proposed regulations was that since LLCs didn't exist when Congress created §1402(a)(13), we'll essentially look to see if the LLC "could have been" organized as a limited partnership and if the member in question "could have been" a limited partner. So, under this view, a

4 This issue is covered in much greater detail in a June 5, 2003 article by Burgess J.W. Raby and William L. Raby in *Tax Notes Today*, "Self-Employment Income of LLC 'Partners'", 2003 TNT 108-49. The article was a useful resource for preparing this presentation.

member is not subject to self-employment tax if:

1. the individual is not a manger of the LLC;
2. the LLC could have been formed as a limited partnership in the state in question **and**
3. the member would have qualified as a limited partner under state law in that theoretical limited partnership

It is important to note that these proposed regulations predated "check the box" so that, in 1994, an entity would first have to have cleared the hurdles to be treated as a partnership under the prior law "facts and circumstances" style test. On January 1, 1997 the check the box revolution hit LLCs.

During 1997 the IRS rolled out the new proposed regulations dealing with defining a limited partner under §1402(a)(13), in part to deal with the new reality that check the box gave the entity classification world. But those regulations would prove to be extremely controversial.

1997 Proposed Regulations. The 1997 proposed regulations, like check the box, essentially ignored the state law structure of the entity. Instead, these regulations sought to define a "limited partner" for §1402(a)(13) based on a set of relatively objective tests—none of which involved seeing if the entity in question was a limited partnership under state law or even if it could be a limited partnership.

An individual generally would be treated as a limited partner unless the individual:

- has personal liability for the debts of or claims against the LLC by reason of being a member;
- has authority to contract on behalf of the LLC under the statute or law under which the LLC is organized; **or**
- participates in the LLC's trade or business for more than 500 hours during the tax year[5]

However, in what proved to be extremely controversial, regardless of meeting the above test, the proposed regulations denied limited partnership status to a *service partner* in a *service partnership*.[6]

A "service partner" was defined as a partner "who provides services to or on behalf of the service partnership's trade or business."[7] An exception was made for a partner who provides only *de minimus* services.

5 Proposed Regulation §1.1402(a)-2(h)(2)

6 Proposed Regulation §1.1402(a)-2(h)(5)

7 Proposed Regulation §1.1402(a)-2(h)(6)(ii)

A "service partnership" was defined as an entity with substantially all of its activities involved in the performance of services in the fields of "health, law, engineering, architecture, accounting, actuarial science, or consulting."[8]

As noted, Congress moved to block the implementation of these regulations and even though that prohibition long ago expired, the proposed regulations have neither been withdrawn nor made final.

Current Positions. Practitioner interpretation of what all this meant was mixed. Some would argue that the Code itself is clear, and that a limited partnership has a very specific definition under state law. The argument would go that if an entity was not organized as a limited partnership under state law and the member is not a limited partner, the individual cannot make use of §1402(a)(13), and so under the general rule all trade or business income is self-employment income for an LLC member. However, they would argue, if a person qualifies as a limited partner under state law, only guaranteed payments that are service related would be subject to self-employment regardless of the application of the factors discussed in the 1997 Proposed Regulations.

A second option is to apply the 1997 Proposed Regulations even though they have never been made final . The IRS has informally indicated in some forums that they will accept the application of the 1997 Proposed Regulations until the situation is further clarified.

Finally, some like the 1994 Proposed Regulations, despite the fact they never became final regulations and were withdrawn. The apparent theory to support this position is that the IRS considered this a "reasonable" interpretation of Congressional intent when they enacted §1402(a)(13) based on the fact that LLCs did not exist at that time. Of course, this ignores the basic problem that these regulations were based on a classification mechanism that is no longer in place, so they are being tested against entities that previously would have already "failed" to be a partnership under the law.

Practitioners should consider that whatever position a taxpayer takes, it likely needs to be consistent for that taxpayer (switching back and forth from year to year likely isn't going to work) but it appears that more than one position is supportable in many cases. Taxpayers may very well need to be counseled about the possible positions and exposure they would have in order to make an informed decision about what position they wish to take on their LLC income. As well, practitioners need to consider that the IRS could very use a taxpayer's broad view of what is a limited partnership against the taxpayer if the question at issue is not whether income is self-employment income under §1402(a)(13), but whether a loss comes from a limited partnership and is by definition a passive activity loss per the limited partnership rules found at §469(h)(2).

Payments for Tenure Rights

In the case of *Appolini, Sr., et al v. United States* (West. Dist. Mich., So. Div., 2004-2 USTC ¶50,333), the IRS prevailed in defending against a refund suit looking for a refund of FICA taxes withheld on the payment to teachers for tenure rights in a termination offer. The judge in this case specifically rejected the holding of the 8th Circuit Court of Appeals in

8 Proposed Regulation §1.402(a)-2(h)(6)(iii)

North Dakota State University v. United States (2001-2 USTC ¶50,485) where that court held that tenure rights paid to faculty members for giving up their tenure rights.

In *North Dakota State University*, the court essentially found that the faculty voluntarily surrendered a right and did not find the payments to be similar to dismissal payments. The court emphasized those rights given up and that the payments were not totally dependent on past performance and current salary, and tenure was not an "automatic" right that the faculty could demand based solely upon the attainment of a certain number of years of service.

In *Appolini*, the court both distinguished the facts from those that existed in *North Dakota State University* and specifically declined to follow the *North Dakota* analysis to the extent the case could not be distinguished. The court emphasized that teachers received their tenure right after completion of their probationary period. Though the teachers also had to meet other requirements, past service was a very important, if not primary condition of obtaining tenure in this case.

The court also noted that it did not accept the idea that the mere fact that tenure might be a property right subject to due process protection somehow exempted the payment from FICA taxation. Rather, the court emphasized that payments for services should be interpreted broadly and that these payments came within that view.

Signing Bonuses

The IRS issued two Revenue Rulings *(Revenue Rulings 2004-109 and 2004-110)* that held that a payments received for entering into an employment contract (baseball player signing bonus and bonuses paid upon ratification of a collective bargaining agreement) and a payment received for terminating employment are FICA wages, continuing a broad brush view of renumeration for employment that would fit the definition of §3121(a). Like the cases noted above, the questions revolve around payments made to individuals who have an employment relationship, but who receive payments not directly tied to the performance of specific services.

In Ruling 2004-109, the IRS rules on payments made as consideration to initiate employment prior to the rendering of services. The IRS considered both payments made in exchange for the ratification of a collective bargaining agreement and payments made to a baseball player as a signing bonus.

In the baseball player example, the player signs a contract that pays a player a bonus if the player simply reports for spring training at the time and place directed by the club. The contract also provides that this payment is not contingent on the future performance of services by the player. In the case of the collective bargaining agreement, the agreement provided that upon ratification, each employee of the company on the ratification date covered by the agreement would be paid a bonus, an amount that would be identical for each employee regardless of position, compensation or seniority. The payment was not contingent on the performance of future services and is payable even to individuals that had not yet performed any services for the employer as of the ratification date.

In Revenue Ruling 58-145, the IRS had previously ruled that a baseball player's signing bonus was *not* subject to FICA. In this ruling, the IRS announces that the previous ruling is in error and revokes that ruling. The IRS now holds that since these payments are related to the employment arrangement between the employer and employee, they constitute "renumeration for employment" as described by §3121(a) and are subject to FICA tax.

Having decided that being paid to initiate employment is FICA taxable, in the next ruling the IRS turns to the question of payments to an employee to terminate employment. Given the IRS arguments in the *North Dakota State University* and *Appolini* cases noted above, not surprisingly the IRS holds that termination payments are subject to FICA.

In the facts in Revenue Ruling 2004-110, the employee has a contract with the employer providing for a specified number of years of employment. The contract does not provide for any payments to be made by either party if the contract is canceled by mutual agreement. Before the end of the agreement, the parties agree that the employer will pay the employee a payment in exchange for the employee relinquishing of his contract rights for the remaining period covered by the contract.

Previously, in Rulings 55-520 and 58-301, the IRS had held that similar payments were not FICA wages. As with with the signing bonus, the IRS has now had a change of heart and has modified and superseded those rulings so far as they concluded on the payroll tax classification of such payments.[9]

9 The ruling left unchanged the IRS position that the payments are ordinary income and not capital gain. The IRS considers such payments not a sale of property for these purposes, but simply a substitute for ordinary income that otherwise would have been received.