SELF-EMPLOYMENT TAXES AND PASSTHROUGH ENTITIES: WHERE ARE WE NOW?

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In this report, the authors review the history of the application of the self-employment tax provisions of section 1402 to members of entities taxed as partnerships that do not fit the statutory labels of “general partners” and “limited partners.” They also summarize the guidance available to practitioners.

The views reflected in this article are those of the coauthors and do not reflect the position of the American Bar Association Section of Taxation.

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I. History

A. NESE — In General

Individuals1 earning income as sole proprietors from a trade or business generally are required to treat ordinary income from that trade or business as net earnings from self-employment (NESE).2 NESE does not include capital gains,3 rentals from real property,4 interest on indebtedness issued by a corporation or governmental entity,5 and

1Unless otherwise indicated, this article assumes: (i) individuals own the equity interests in the entity; (ii) the entity and its owners all have the same tax year; and (iii) the entity is engaged in a trade or business.
2Section 1402(a). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder.
3Section 1402(a)(5).
4Section 1402(a)(1).
5Section 1402(a)(2). Interest received in the course of a trade or business as a dealer in stocks or securities is included in NESE.
dividends (collectively, Excluded Income). As a general rule, a partner in a partnership is required to include in NESE the partner’s distributive share of income or loss described in section 702(a)(8) (regardless of whether distributed) from a trade or business conducted by the partnership.

NESE is subject to the old age, survivors, and disability insurance and hospital insurance taxes under section 1401 (Self-Employment Tax). For 2005 the Self-Employment Tax is imposed at the rate of 15.3 percent on the first $90,000 of NESE and 2.9 percent on amounts in excess of $90,000. Individuals are entitled to an above-the-line deduction equal to one-half of the Self-Employment Tax.

B. NESE — Limited Partners

Notwithstanding the general rule that a partner’s distributive share of income or loss constitutes NESE, NESE does not include a limited partner’s distributive share of income or loss (other than distributions that are guaranteed payments as compensation for services actually rendered to the partnership) to the extent that it is established that those payments are remuneration for services to the partnership. According to committee reports, section 1402(a)(13) was added in 1977 to prevent passive investors who do not perform services from obtaining Social Security coverage. Before the change, limited partners were able to treat their distributive share of partnership income as NESE, which therefore qualified as earnings for Social Security benefits, even though the limited partners were not engaged in the business of the partnership and remained passive investors with limited liability protection. With the addition of section 1402(a)(13), limited partners include only guaranteed payments for services as NESE and do not include any part of their distributive share of partnership income or loss. In other words, as a result of section 1402(a)(13), the determination of NESE incorporates the historical legal distinction between general partners (as participating in the business of the partnership) and limited partners (as being passive investors).

The legislative history to section 1402(a)(13) also indicates that this provision is intended to apply separately to limited partnership interests and general partnership interests, even if those interests are held by the same partner. Although there are no regulations identifying limited partners for the purposes of that provision, both the legislative history and the plain language of the statute suggest that a state law limited partner who actually performs services for the partnership should include in NESE at least the guaranteed payments directly attributable to those services.

C. NESE — LLC Members

A member’s share of the income of a limited liability company may be classified in one of three ways: (i) as wages; (ii) as NESE; or (iii) as a distributive share of partnership income that is neither wages nor NESE. The classification is significant in determining not only whether a member’s share of LLC income is subject to Self-Employment Tax, but also whether the income may serve as a basis for contributions to a qualified plan for tax purposes. In the context of a partnership, if a partner provides services to the partnership, their distributive share of income may not be treated as wages.

The plain language of section 1402(a)(13), which excludes from NESE the distributive share of income of limited partners, suggests that the distributive share of a person who is not a state law limited partner (for example, a member in an LLC) should be NESE.

Since 1977, however, a number of legal changes have occurred to diminish the effectiveness and usefulness of the distinction between general partners under the general rule of section 1402(a) and the exemption for state law limited partners under section 1402(a)(13). First, state partnership statutes have redefined limited partners to minimize the distinction between general and limited partners based on control or participation in the activities of the partnership. In 1977 most state limited partnership statutes provided that a limited partner would be liable as a general partner if they took part in controlling the

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6Id. Dividends received in the course of a trade or business as a dealer in stocks or securities are included in NESE.
7Some types of ordinary income (for example, meals and lodging provided to ministers and retirement payments made to partners) are also excluded from NESE. Sections 1402(a)(8) and (10).
8For purposes of this article, the term “partnership” is used to refer to any entity classified as a partnership for federal income tax purposes, and the term “partner” is used to refer to an owner of a tax partnership.
10Section 1402(a)(13); Rev. Rul. 79-53, 1979-1 C.B. 286.
12Id.
13The statute provides 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 services.” Section 1402(a)(13) (emphasis added).
14Conversely, a general partner is required to include in NESE his entire distributive share of income or loss from the partnership even if he does not perform services for the partnership. Section 1402(a).
15Section 3121(a). In contrast to NESE, the employee and the employer each pays one-half of the old-age, survivors, and disability insurance and hospital insurance taxes for wages. Sections 3101 and 3111.
16Section 1402(a).
17Section 702.
18Section 401(c)(1)(B).
business of the partnership. Limited partners now can maintain their limited liability even if they are active in the partnership business. Second, LLCs have risen in popularity to become the pass-through entity of choice in many situations. The two general forms of LLCs (manager-managed and member-managed) resemble limited partnerships and general partnerships, respectively, but they are not identical to those older business forms. The manager of a manager-managed LLC has management and agency authority while the members do not; nevertheless, the members may be active in the operation of the business of the LLC. In a member-managed LLC, management is generally vested in the members, although an operating agreement is extremely flexible in how it may define their involvement in the business activities of the LLC. Finally, the check-the-box regulations give taxpayers the ability to elect between business activities of the LLC. Finally, the check-the-box flexible in how it may define their involvement in the business of the LLC. In a member-managed LLC, management is generally vested in the members, although an operating agreement is extremely flexible in how it may define their involvement in the business activities of the LLC. Finally, the check-the-box regulations give taxpayers the ability to elect between the partnership and corporate tax regimes thereby further blurring the distinction between partnerships and other business organizations.

D. 1994 Proposed Regulations

On December 28, 1994, proposed Treas. reg. section 1.1402(a)-18 (the 1994 Proposed Regulations) was released dealing with "Self-Employment Tax Treatment of Members of Certain Limited Liability Companies." Under the 1994 Proposed Regulations, a member of a manager-managed LLC would have been treated as a limited partner for purposes of section 1402(a)(13) if: (i) the member was not a manager of the LLC; (ii) the LLC could have been formed as a limited partnership rather than an LLC in the same jurisdiction; and (iii) the member could have qualified as a limited partner in that limited partnership under applicable state law.

For purposes of the 1994 Proposed Regulations, a "manager" was "a person who, alone or together with others, was vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed." If there were no elected or designated managers, all members were treated as managers — and as a consequence, all income (other than Excluded Income) in a member-managed LLC constituted NESE under the 1994 Proposed Regulations.

There were two areas of uncertainty in the 1994 Proposed Regulations:

25For example, section 7 of the Uniform Limited Partnership Act (superseded 1976) provides that "[a] limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." For example, section 303 of the Uniform Limited Partnership Act (1976) includes an extensive list of activities in which a limited partner may participate without being treated as having participated in the control of the business of the partnership.

26Prop. Treas. reg. section 1.1402(a)-18(c)(3).

(1) When does an LLC have an elected or designated manager?
(2) When would a member cease to be treated as a limited partner if, instead of organizing an LLC, the members had formed the business as a limited partnership?

Under the 1994 Proposed Regulations, a member would have been treated as a limited partner if the LLC had designated or elected managers and the member was not a manager. The 1994 Proposed Regulations suggested that there did not need to be a manager-member so that, at least for purposes of determining NESE, no member in a nonmember, manager-managed LLC would be subject to Self-Employment Tax.

The second requirement under the 1994 Proposed Regulations (that is, the member could have qualified as a limited partner if the LLC were a limited partnership under applicable law) depended on the member’s participation in the control of the LLC. It would have been extremely difficult to determine how much a member could participate in the control of the business without losing limited liability, if the LLC were organized as a limited partnership. For example, under section 303(a) of the Revised Uniform Limited Partnership Act, a limited partner is liable as a general partner if the partner participates in the control of the business.

E. AICPA Proposal

On February 19, 1998, the American Institute of Certified Public Accountants submitted a proposal (the AICPA Proposal) for the taxation of partners and sole proprietors. That proposal would require a legislative change, but has the benefit of providing common bright-line rules.

The AICPA Proposal states that, to the extent that LLCs and partnerships elect or default to partnership
status for federal tax purposes, general and limited partners and LLC members who are individuals should be treated in the same manner for Self-Employment Tax purposes. Under the AICPA Proposal, every partner (including every LLC member), except as otherwise provided in section 1402(a), would pay Self-Employment Tax on the value of the services they perform for or on behalf of the partnership (or LLC). The value of the services performed would be based on the general standard of reasonableness that would be determined under either facts and circumstances or a safe harbor test. Partners or LLC members who receive a reasonable section 707(c) guaranteed payment for services would not be subject to Self-Employment Tax on their distributive share of partnership income under section 702(a)(8) but instead would be taxed only on the guaranteed payment.

The AICPA Proposal includes a safe harbor for determining the reasonableness of the value of services performed by partners. If a partner’s reported NESE varied from the safe harbor amount by 10 percent, the amount of NESE would be subject to reasonableness testing on the basis of facts and circumstances. The safe harbor amount would be equal to the partner’s distributive share of partnership income or loss under section 702(a)(8) plus section 707(c) guaranteed payments for services less a reasonable rate of return on the partner’s capital account at the beginning of the year (which could not be less than zero), calculated on the same basis as the reported taxable income of the partnership. The rate of return on the partner’s capital account would be deemed to be reasonable if the rate used is 150 percent of the applicable federal rate at the end of the partnership’s tax year.

The AICPA Proposal includes a de minimis exception for partners who perform less than 100 hours of services for the partnership during a 12-month partnership tax year (or for a proportionate number of hours in the case of a short tax year or where a partner joins the partnership during the year). Also, the AICPA Proposal includes specific antiabuse provisions.33

F. S Corporations

In contrast to the problem of classifying LLC members for Self-Employment Tax purposes, the employment tax treatment of C corporation and S corporation shareholder-employees is more definite.34 Nevertheless, there are many stories of shareholder-employees either paying themselves unreasonably high compensation (in the case of a C corporation)35 or unreasonably low compensation (in the case of an S corporation).36 Regarding S corporation shareholder-employees, recent legislative proposals have suggested addressing the problem by treating shareholder-employees in the same manner as partners.37

An S corporation employee is subject to employment taxes on the amount of his reasonable compensation, even though the amount may have been characterized as other than wages.38 A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S corporations constitute reasonable compensation and therefore are wages subject to the employment taxes, or rather are properly characterized as another type of income that is not subject to employment taxes.39

In cases addressing whether payments to an S corporation shareholder-employee were wages for services or were corporate distributions, courts have characterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.40 In recent cases involving whether reasonable compensation was paid (not exclusively in the

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32The AICPA Proposal also states that, within some limitations, sole proprietors should be treated in the same manner. However, a discussion of sole proprietorships for Self-Employment tax purposes is beyond the scope of this article.

33For example, the AICPA Proposal requires: (i) aggregation of partnership interests (applying section 267(e)(3)) to prevent partners from using the de minimis exception to avoid paying Self-Employment Tax; and (ii) aggregation of two or more partnerships if more than 50 percent are owned by the same persons.

34Section 3101.
As discussed above, one of the problems in applying the statutory regime of section 1402 is that it is difficult to determine who are “general partners” and who are “limited partners” in the various forms of unincorporated business entities in use today.

2. Bifurcation of partnership interests. Under the code and existing Treasury regulations, the nature of the partnership interest owned by an individual controls whether that individual’s distributive share of partnership Business Income is treated as NESE. As the same individual can be both a general partner and a limited partner in a state law limited partnership, an individual can bifurcate his distributive share of partnership Business Income into a NESE portion (the distributive share attributable to the interest as a general partner) and non-NESE portion (the distributive share attributable to the interest as a limited partner).

3. Flowchart depicting operation of the statute. The following flowchart depicts operation of the statute in determining NESE of a partner in a limited or general partnership.

B. 1997 Proposed Regulations

1. General approach of 1997 proposed regulations. The 1994 Proposed Regulations were criticized for their reliance on state law. Because of that reliance and differences in state law, it was argued that similarly situated taxpayers could be treated differently in determining NESE for

had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

\[43\]In Metro Leasing and Dev. Corp. v. Commissioner, 376 F.3d 1015, 1019, Doc 2004-15269, 2004 TNT 143-19 (9th Cir. 2004), the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other circuits that apply the multifactor test through the lens of the independent investor test, citing KAPCO Inc. v. Commissioner, 85 F.3d 950, Doc 96-17155, 96 TNT 114-8 (2d Cir. 1996).

\[44\]See, e.g., Haffner’s Service Stations Inc. v. Commissioner, 326 F.3d 1, Doc 2003-8201, 2003 TNT 63-17 (1st Cir. 2003).

\[41\]Exacto Spring Corp. v. Commissioner, 196 F.3d 833, Doc 1999-36657, 1999 TNT 222-6 (7th Cir. 1999).

\[42\]The independent investor test has been examined and partially adopted in some other circuits, changing the analysis under the multifactor test. The Seventh Circuit, however, has adopted an “independent investor” analysis differing from the multifactor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The independent investor test to determine reasonable compensation, including such factors as whether the individual’s compensation was comparable to compensation paid at similar firms.

\[45\]H.R. Rep. No. 95-702, supra note 12, provides that “[d]istributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.” 1978-1 C.B. 469, 477.

S corporation context), courts have applied a multifactor test to determine reasonable compensation, including such factors as whether the individual’s compensation was comparable to compensation paid at similar firms.

II. Current Law and Guidance

A. Section 1402

1. Statute and existing Treasury regulations. Section 1402(a) defines the NESE of an individual as including:

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.

That general rule is subject to a number of specific statutory exceptions, including section 1402(a)(13), which excludes the distributive share of a limited partner (other than guaranteed payments for services actually rendered to the partnership to the extent that those payments constitute remuneration for those services) from being treated as NESE. Thus the statute includes all the distributive share of income (other than Excluded Income) of a general partner in a partnership as NESE.

The statutory distinction between general partners and limited partners does not distinguish between service partners and purely investment partners. Treas. reg. section 1.1402(a)-2(g), adopted in 1963 and amended in 1974 (before the adoption of section 1402(a)(13)), provided as follows:

The net earnings from self-employment of a partner include his distributive share of the income or loss, described in section 702(a)(9), of the partnership of which he is a member, irrespective of the nature of his membership. Thus, in determining his net earnings from self-employment, a limited or inactive partner includes his distributive share of such partnership income or loss. (Emphasis added.)
Self-Employment Tax purposes. Consequently, on January 13, 1997, the 1994 Proposed Regulations were withdrawn and replaced with a new set of proposed regulations46 (the 1997 Proposed Regulations) for determining NESE of a partner in a partnership. The 1997 Proposed Regulations attempt to provide a mechanism for applying the distinction made by the code between general and limited partners in a world in which the titles given to owners in entities that are treated as partnerships for federal income tax purposes do not contain those historic labels. The preamble to the 1997 Proposed Regulations expressed the goal as follows:

The proposed regulations contained in this document define which partners of a federal tax partnership are considered limited partners for section 1402(a)(13) purposes. These proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity. Thus, the same standards apply when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC. In order to achieve this conformity, the proposed regulations adopt an approach which depends on the relationship between the partner, the partnership, and the partnership’s business. State law characterizations of an individual as a “limited partner” or otherwise are not determinative.

2. Operation of 1997 proposed regulations.47

a. General rule. Under section 1.1402(a)-2(h)(2) of the 1997 Proposed Regulations (the General Rule), an individual who is a partner in a partnership is treated as a limited partner (and therefore subject to the statutory exclusion under section 1402(a)(13)) unless the individual either (i) has personal liability for debts or claims against the partnership (the Liability Test),48 (ii) has authority under local partnership law to contract on behalf of the partnership (the Authority Test),49 or (iii) participates in the partnership’s trade or business for more than 500 hours per year (the 500-Hour Test).

b. Exceptions.

i. Exception for partners who hold two classes of interest. Under section 1.1402(a)-2(h)(3) of the 1997 Proposed Regulations (the Multiple Class of Interest Exception), an individual who holds more than one class of partnership interest in a partnership and who does not meet the definition of a limited partner under the General Rule can still be treated as a limited partner with respect to one of those classes of partnership interest if (i) partners who meet the General Rule definition of a limited partner own a substantial continuing interest in that class, and (ii) the rights and obligations of all holders of that class of partnership interest are identical. For that purpose, section 1.1402(a)-2(h)(6)(iv) provides that a substantial interest in a class of interest is determined based on all of the relevant facts and circumstances, but that in all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

ii. Exception for partners who materially participate and hold a single class of partnership interest. Under section 1.1402(a)-2(h)(4) of the 1997 Proposed Regulations (the Single Class of Interest Exception), an individual who does not meet the definition of a limited partner under the General Rule solely because that individual fails the 500-Hour Test can still be treated as a limited partner if (i) partners who meet the General Rule definition of a limited partner own a substantial continuing interest in the same class of partnership interest as that owned by the individual and (ii) the rights and obligations of all holders of that class of partnership interest are identical. The Single Class of Interest Exception does not apply to individuals who are treated as general partners by reason of the Liability Test or the Authority Test.

c. Treatment of service partners in a service partnership. Under section 1.1402(a)-2(h)(5) of the 1997 Proposed Regulations, an individual who is a service partner in a service partnership cannot qualify as a limited partner under the General Rule or either the Multiple Class of Interest Exception or the Single Class of Interest Exception. A service partner is a partner who provides services to or on behalf of a service partnership’s trade or business.50 An individual is not considered to be a service partner if they provide only a de minimis amount of services to or on behalf of a service partnership.51 A service partnership is a partnership in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (a 1997 Proposed Regulations Service Partnership).52

Footnote continued on next page.

47A 1997 JCT report goes further than the 1997 Proposed Regulations, recommending legislation that would treat members and partners as employees with respect to all guaranteed payments for services under section 707(c) or deemed non-partner payments under section 707(a). Also, the distributive share of Business Income of all limited partners or members who participate in the business of the limited partnership or the LLC in excess of a certain number of hours would be treated as NESE.
48The Liability Test under the 1997 Proposed Regulations considers a partner’s liability under state law and the partnership or other ancillary agreements.
49The Authority Test under the 1997 Proposed Regulations considers only a partner’s authority under state law.
50Prop. Treas. reg. section 1.1402(a)-2(h)(6)(ii).
51Because the definition of service partner excludes individuals who provide a de minimis amount of services, it is possible to have a partner in a service partnership whose distributive share of partnership Business Income is not treated as NESE.
52Prop. Treas. reg. section 1.1402(a)-2(h)(6)(iii). The definition of a 1997 Proposed Regulations Service Partnership does not include an entity in which substantially all of the activities...
3. Flowchart depicting operation of 1997 proposed regulations. The flowchart above depicts operation of the 1997 Proposed Regulations in determining whether a partner include performing arts, like the definition of a JCT Service Partnership under the JCT Proposal. See note 73 infra.

4. Application to specific types of business entities. 
   a. General partnership. Under most if not all state partnership laws, all partners in a general partnership have personal liability for the debts and obligations of the partnership and at least apparent authority to contract on
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behalf of the partnership. Thus, in a general partnership no partner can be treated as a limited partner under the General Rule. As there are no partners who can meet the General Rule definition of a limited partner, there also cannot be any partners who meet either the Multiple Class of Interest Exception or the Single Class of Interest Exception because each of those exceptions depends on there being partners meeting the General Rule definition of a limited partner who hold a continuing and substantial interest in a specific class of partnership interest.

Therefore, under the 1997 Proposed Regulations, all partners of a general partnership will continue to have their entire distributive share of partnership Business Income treated as NESE. Neither being a passive investor who does not provide any services nor having a separate class of partnership interest (for example, a preferred class of interest with rights similar to a preferred shareholder) would shield a general partner from NESE.

b. Limited liability partnership. Under most state LLP laws, the partners of the LLP do not have personal liability for the debts and obligations of the LLP. However, for other state law purposes, the partners of an LLP are general partners and all LLP partners have apparent authority to contract for the LLP. Therefore, no LLP partner can meet the General Rule definition of a limited partner for Self-Employment Tax purposes. Furthermore, as there are no partners in an LLP who can meet the General Rule definition of a limited partner, there also cannot be any LLP partners who meet either the Multiple Class of Interest Exception or the Single Class of Interest Exception because each of those exceptions depends on there being partners meeting the General Rule definition of a limited partner who hold a continuing and substantial interest in a specific class of partnership interest.

Therefore, under the 1997 Proposed Regulations, all partners of an LLP will continue to have their entire distributive share of partnership Business Income treated as NESE.

c. Limited partnership.

i. General partner. For a general partner in a limited partnership who does not also hold a limited partnership interest, the general partner’s distributive share of the limited partnership’s Business Income would be treated as NESE. Under most if not all state limited partnership laws, the general partner has personal liability for debts and obligations of the limited partnership and has express authority to contract for the limited partnership. Therefore, under the 1997 Proposed Regulations a general partner in a limited partnership cannot meet the General Rule definition of a limited partner.

ii. Limited partner. Under most if not all state limited partnership laws, a limited partner does not have personal liability for debts and obligations of the limited partnership and does not have apparent authority to contract for the limited partnership. Thus, under the General Rule, a limited partner who does not fail the 500-Hour Test will be treated as a limited partner for Self-Employment Tax purposes. Even if the limited partner fails the 500-Hour Test (provided he is not a service partner in a 1997 Proposed Regulations Service Partnership), the limited partner may be treated as a limited partner for Self-Employment Tax purposes under either the Multiple Class of Interest Exception or the Single Class of Interest Exception. Both of those exceptions require that state law limited partners who do not provide more than 500 hours of service for the limited partnership own a continuing and substantial interest in the class of partnership interest held by the limited partner seeking the benefit of the exceptions. Thus, a limited partnership with a single limited partner who fails the 500-Hour Test could not meet either of those exceptions.

iii. General partner who also holds limited partnership interest. As discussed above, the general partnership interest held by a general partner cannot meet the limited partner exclusion from NESE. However, if an individual who holds a general partnership interest also holds a limited partnership interest, the Multiple Class of Interest Exception may apply to allow the distributive share of partnership Business Income attributable to the limited partnership interest not to be treated as NESE.

That requires that there be other limited partners in the limited partnership who hold the same class of limited partnership interest and who meet all the requirements of the General Rule, including the requirement that they do not fail the 500-Hour Test. Those other limited partners must hold a substantial and continuing interest in that class of limited partner interest.

iv. Service partner in a service partnership. Historically, limited partnerships were not used for professional service partnerships. That was partially due to older form of practice restrictions and partially based on older versions of limited partnership acts that created the risk that a limited partner that was actively involved in running the business of the limited partnership might be treated as a general partner for liability purposes to the extent that other persons believed the limited partner was a general partner. However, the practice restrictions on using limited liability entities to provide professional services have been relaxed and modern limited partnership acts have eliminated or limited the exposure of being treated as a general partner for liability purposes. There are anecdotal accounts of professional firms converting to limited partnerships in which the professional service providers are limited partners who actively perform professional services. Under section 1.1402(a)-2(h)(5) of the 1997 Proposed Regulations, an individual who is a service partner (whether a general partner or a

53For example, ABA Committee on Ethics and Professional Responsibility, Informal Op. 865 (1965), concludes that a lawyer may not ethically practice as a limited partner in a law firm.

54For example, ABA Committee on Ethics and Professional Responsibility, Formal Op. 96-401 (1996), concludes that lawyers may practice in an LLP or a limited liability limited partnership if the applicable law provides that the lawyer rendering legal services remains personally liable to the client, the requirements of the law of the relevant jurisdiction are met, and the form of business organization is accurately described by the lawyers in their communications.

55For example, section 303 of the Uniform Limited Partnership Act (2001) provides that limited partners now can maintain their limited liability even if they are active in the partnership business.
limited partner for state law purposes) in a 1997 Proposed Regulations Service Partnership cannot qualify as a limited partner for Self-Employment Tax purposes under the General Rule or either the Multiple Class of Interest Exception or the Single Class of Interest Exception.

d. Limited liability limited partnership (LLLP).

i. General partners. Under most state LLLP laws, the general partners of the LLLP do not have personal liability for the debts and obligations of the LLLP. However, for other state law purposes, the general partners of an LLLP have the same authority and management rights as the general partners of a limited partnership and therefore have apparent authority to contract for the LLLP. Therefore, no LLLP general partner can meet the General Rule definition of a limited partner for Self-Employment Tax purposes under the 1997 Proposed Regulations. However, if the individual who holds a general partnership interest in an LLLP also holds a limited partnership interest, the Multiple Class of Interest Exception may apply to make the distributive share of partnership Business Income attributable to the limited partnership interest not be treated as NESE. That requires that there be other limited partners in the LLLP who hold the same class of limited partner interest and who meet all the requirements of the General Rule, including the requirement that they do not fail the 500-Hour Test. Those other limited partners must hold a substantial and continuing interest in that class of limited partner interest.

ii. Limited partners. The treatment of a limited partner in an LLLP for Self-Employment Tax purposes under the 1997 Proposed Regulations would be identical to the treatment described above for limited partners in state law limited partnerships.

e. Limited liability company.

i. Member-managed LLC. Under most state LLC laws, all members of a member-managed LLC have apparent authority to contract for the LLC. Therefore, even though members of the LLC do not have personal liability for LLC debts and obligations, no member of a member-managed LLC can meet the General Rule definition of a limited partner for Self-Employment Tax purposes under the 1997 Proposed Regulations. Furthermore, as there are no members in a member-managed LLC who can meet the General Rule definition, there also cannot be any LLC members who meet either the Multiple Class of Interest Exception or the Single Class of Interest Exception because each of those exceptions depends on there being members meeting the General Rule definition of a limited partner who hold a continuing and substantial interest in a specific class of membership interest. Therefore, under the 1997 Proposed Regulations, all members of a member-managed LLC will continue to have their entire distributive share of LLC Business Income treated as NESE.

ii. Manager-managed LLC.

a. Nonmanager member. Under most state LLC laws, the managers of a manager-managed LLC have exclusive authority to manage the LLC and members who are not managers do not have apparent authority to contract for the LLC. Thus, under the General Rule, a nonmanager-member in a manager-managed LLC who does not fail the 500-Hour Test will be treated as a limited partner for Self-Employment Tax purposes. Even if the nonmanager-member fails the 500-Hour Test (provided he does not qualify as a service partner in a 1997 Proposed Regulations Service Partnership), the member may be treated as a limited partner for Self-Employment Tax purposes under either the Multiple Class of Interest Exception or the Single Class of Interest Exception. Both of those exceptions require that nonmanager-members who do not provide more than 500 hours of service for the LLC own a continuing and substantial interest in the class of membership interest held by the nonmanager-member seeking the benefit of the exceptions. Thus, a manager-managed LLC with a single nonmanager-member who fails the 500-Hour Test could not meet either of those exceptions.

b. Manager-member. Manager-members in a manager-managed LLC have apparent authority to contract on behalf of the LLC. Therefore, even though manager-members do not have personal liability for LLC debts and obligations, a manager-member cannot qualify as a limited partner for Self-Employment Tax purposes under the General Rule. However, if the individual who holds a membership interest as a manager-member also holds a second economic class of membership interest, the Multiple Class of Interest Exception may apply to make the distributive share of LLC Business Income attributable to the second class of membership interest not be treated as NESE. That requires that there be nonmanager-members in the LLC who hold the same class of membership interest and who meet all the requirements of the General Rule, including the requirement that they do not fail the 500-Hour Test. Those other nonmanager-members must hold a substantial and continuing interest in that class of membership interest. Note that a manager-member in a manager-managed LLC cannot meet the Single Class of Interest Exception because the manager-member does not fail to meet the General Rule solely because he provides more than 500 hours of service. The possession of apparent authority to bind the LLC takes the manager-member out of the Single Class of Interest Exception.

The Authority Test may be problematic for Delaware LLCs. Under the Delaware Limited Liability Company Act (unlike most state LLC statutes), the fact that an LLC has a manager does not eliminate the members’ apparent authority to contract on behalf of the LLC. A Delaware LLC is not designated as manager-managed in its certificate of formation filed with the state. Management of a Delaware LLC is vested in its members unless otherwise provided in the LLC’s limited liability company agreement. Del. Code Ann. Tit. 6, section 18-402 (2005). In the absence of a provision in the limited liability company agreement limiting the members’ authority, the members of a manager-managed Delaware LLC still have authority to contract on behalf of the LLC. It is not entirely certain whether a provision in a limited liability company agreement limiting the members’ authority would be sufficient for the members not to be treated as having authority under Delaware law to contract on behalf of the LLC.
iii. Service LLC. Under section 1.1402(a)-2(h)(5) of the 1997 Proposed Regulations, an individual who is a service partner (whether a manager or a nonmanager, and whether the LLC is member-managed or manager-managed for state law purposes) in a 1997 Proposed Regulations Service Partnership cannot qualify as a limited partner for Self-Employment Tax purposes under the General Rule or either the Multiple Class of Interest Exception or the Single Class of Interest Exception.

5. The Moratorium and its aftermath. Section 935 of the Taxpayer Relief Act of 199757 (the Moratorium) provided that "[n]o 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." Considering that the Moratorium has expired, it is unclear what remaining legal effect the Moratorium has on finalization of the 1997 Proposed Regulations. A Senate resolution urging withdrawal of the 1997 Proposed Regulations was considered as part of the legislative process when the Moratorium was passed, but the final legislation merely provided that no regulations be issued.

The Moratorium continues congressional misconception of the operation of limited partnerships at the expense of providing workable guidance to LLCs. Arguably, the effect of the 1997 Proposed Regulations on state law limited partnerships is trivial at best because limited partnerships are largely being supplanted by LLCs and because the vast majority of the remaining limited partnerships would likely not be affected by the regulations. Inasmuch as under state limited partnership acts a limited partner does not have personal liability or authority to bind the limited partnership, the only limited partners who would be affected by the 1997 Proposed Regulations would be (i) those who fail the 500-Hour Test (and then only if the interest held by that limited partner is not identical to the interest of other limited partners who have a substantial and continuing interest in the limited partnership and who do not fail the 500-Hour Test), and (ii) limited partners in 1997 Proposed Regulations Service Partnerships. While there may be some limited partnerships in which all limited partners fail the 500-Hour Test, those should be quite exceptional.58

The other possible application of the 1997 Proposed Regulations to service partners in service partnerships would be limited partnerships devoted to health, law, engineering, architecture, accounting, actuarial science, or consulting. Assuming that it is inappropriate from a policy standpoint to treat limited partners in a 1997 Proposed Regulations Service Partnership as being subject to Self-Employment Tax, the number of limited partners who would be affected should not be significant in comparison to determining the Self-Employment Tax treatment of all individual members in LLCs.

Regardless of how ill-advised the Moratorium was, individual members of LLCs still must determine how to treat their distributive share of Business Income from an LLC. As a result of the Moratorium, it is doubtful that the 1997 Proposed Regulations will ever be finalized. As a consequence, members and their advisers will have to determine how to account for their distributive share of Business Income based on the sparse authority available. The only guidance in this area is in the form of private letter rulings concluding that a member is a partner and "the members’ distributive shares of income are not excepted from net earnings from self-employment by Section 1402(a)(13)."59 Those private letter rulings suggest that all members, regardless of the level of their authority or participation in management, are subject to Self-Employment Tax. If that is the correct analysis, individuals wishing to limit their exposure to Self-Employment Tax while maintaining limited liability should use limited partnerships with corporate general partners or S corporations. It should be noted, however, that those private letter rulings were issued when LLCs were relatively new and before the more extensive analysis provided in the 1997 Proposed Regulations.

A second approach would be to assume that all LLC members are "limited partners" under section 1402(a)(13) and, except to the extent members receive guaranteed payments as compensation for services and to the extent that it is established that those payments are remuneration for services to the LLC, the members’ entire distributive share of Business Income is excluded from NESE. There is no authority for that approach under section 1402(a)(13)60 and the private letter rulings discussed above suggest that, to the contrary, a member is presumed to be a general partner unless expressly made a limited partner by regulations.

A third alternative is to assume that the 1997 Proposed Regulations are close to what any final regulations for LLCs will look like, and to draft the LLC operating agreement and report the members’ distributive share of Business Income consistent with those regulations. The dissension over the 1997 Proposed Regulations is not that they make too many individuals limited partners, but that they take the benefits of being a limited partner away from some state law limited partners. That being the case, and regardless of the disagreement between Congress and the IRS, it seems reasonable to assume that any final regulations will resemble or be more generous than the

58 Even Congress recognizes this fact. In discussing the passive loss rules, the Statement of Managers for the Taxpayer Relief Act of 1997 notes that limited partners generally do not materially participate in a partnership’s activities. Doc 97-22325, 97 TNT 148-52.
59 See, e.g., LTRs 9452024, 95 TNT 1-52; 9432018, 94 TNT 159-41; 9525058, 95 TNT 123-82. Because those private letter rulings are more than 10 years old, they generally are "accorded very little weight" in determining whether there is substantial authority. Treas. reg. section 1.6662-4(d)(3)(ii).
60 However, under the passive activity rules, there is authority for treating an interest in an LLC as a limited partnership interest. See Treas. reg. section 1.469-5T(e)(3)(i)(B) ("a partnership interest shall be treated as a limited partner interest if . . . [t]he liability of the holder . . . is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount").
III. Proposals

A. Joint ABA/AICPA Proposal


In June 1999, the ABA Section of Taxation submitted a proposal (the Joint ABA/AICPA Proposal) 64 to Congress for applying the Self-Employment Tax to LLC members and partners in partnerships. Because of the perceived problems with the 1994 Proposed Regulations and the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal recommends amending section 1402 to correct those problems.

Consistent with the basic objective of section 1402, the Joint ABA/AICPA Proposal subjects only the compensatory element of a partner’s distributive share of partnership Business Income to Self-Employment Tax. The Joint ABA/AICPA Proposal makes three recommendations: (i) delete the reference in section 1402(a)(13) to “limited” partner and make that paragraph applicable to any partner; (ii) specify in section 1402(a)(13) that income of a partner attributable to capital is excluded from NESE; and (iii) give the Treasury Department authority to issue any necessary regulations. The Joint ABA/AICPA Proposal includes two safe harbors for determining the income of a partner attributable to capital that is not subject to Self-Employment Tax. Like the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal applies to any entity classified as a partnership for federal income tax purposes and discards distinctions between general partners, limited partners, and LLC members (whether the LLC is member-managed or manager-managed).

The Joint ABA/AICPA Proposal recommends amending the code to provide that income of owners of an entity taxable as a partnership (including an LLC) that is attributable to capital is not subject to Self-Employment Tax. Stated in the converse, the Joint ABA/AICPA Proposal recommends taxing only that portion of a partner’s share of Business Income that constitutes compensation for services provided by the partner to the partnership. The implicit starting point under the Joint ABA/AICPA Proposal is to determine whether a partner provides services to the partnership. A partner who does not provide services to a partnership should not be subject to Self-Employment Tax because compensation is not inherent in his distributive share of partnership Business Income.

If a partner provides services to a partnership, the Joint ABA/AICPA Proposal provides a structure for determining the portion of the partner’s share of Business Income that should be subject to Self-Employment Tax and the portion that should not. The structure is intended to determine the portion of the partner’s share of Business Income that constitutes compensation and the portion that constitutes a return on capital. The Joint ABA/AICPA Proposal includes two safe harbors to facilitate making that determination.

The first safe harbor (the Reasonable Compensation Test) treats as income attributable to capital the amount (if any) in excess of what would constitute reasonable compensation for services rendered by the partner to the partnership. The Reasonable Compensation Test subjects to Self-Employment Tax that portion of a partner’s share of Business Income that constitutes reasonable compensation for the services provided by the partner to the partnership. If the partner’s share of Business Income does not exceed reasonable compensation, the partner’s entire share is subject to Self-Employment Tax, but only to the extent that it fails the Return on Capital Test discussed below.

The second safe harbor (the Return on Capital Test) treats as income attributable to capital an amount equal to a reasonable rate of return on unreturned capital of the partner, determined as of the beginning of any tax year. For purposes of applying the Return on Capital Test, the Joint ABA/AICPA Proposal provides as follows:

The term “unreturned capital” shall mean the excess of the aggregate amount of money and the fair market value as of the date of contribution of other consideration (net of liabilities) contributed by the partner over the aggregate amount of money and the fair market value as of the date of distribution of other consideration (net of liabilities) distributed by the partnership to the partner, increased or decreased for the partner’s distributive share of all reportable items as determined in section 702. If the partner acquires a partnership interest and the partnership makes an election under section 754, the partner’s unreturned capital shall take into account appropriate adjustments under section 743. 65

62Section 6662(d)(2)(B).
64Doc 1999-23633, 1999 TNT 133-23. The Joint ABA/AICPA Proposal states that the ABA Tax Section worked closely with the Tax Division of the AICPA in developing its legislative proposal. The Joint ABA/AICPA Proposal also notes that the ABA Tax Section’s recommendations and the AICPA’s recommendations are identical.

65Joint ABA/AICPA Proposal, supra note 64. The proposal recommends incorporating the suggested definition of unreturned capital into section 1402(a)(13).
A reasonable rate of return on unreturned capital shall equal 150 percent (or such higher rate as is established in regulations) of the highest applicable federal rate, as determined under section 1274(d)(1), at the beginning of the partnership’s tax year.66

The Return on Capital Test subjects to Self-Employment Tax that portion of a partner’s share of Business Income that exceeds a reasonable rate of return on unreturned capital. If the partner’s share of Business Income exceeds a reasonable rate of return on unreturned capital, the excess is subject to Self-Employment Tax except to the extent that it exceeds the amount that would be taxable under the Reasonable Compensation Test.

The Reasonable Compensation Test and the Return on Capital Test are essentially parallel tracks that a taxpayer can consider simultaneously under the Joint ABA/AICPA Proposal. The Joint ABA/AICPA Proposal permits a taxpayer to use the method that results in the least amount of Self-Employment Tax. Informal discussions with representatives from Treasury and the IRS indicate that the government does not want a system under which taxpayers can effectively make an annual election to select the approach that favors them. If forced to choose between the two alternatives, the authors generally prefer the Reasonable Compensation Test over the Return on Capital Test.

2. Flowchart depicting operation of the Joint ABA/AICPA Proposal. The flowchart on the next page depicts operation of the Joint ABA/AICPA Proposal in determining NESE of a partner in a partnership.67

B. JCT Proposal

1. Introduction. On January 27, 2005, the JCT released a report entitled Options To Improve Tax Compliance and Reform Tax Expenditures68 (the JCT Report). Part III. F. of the JCT Report sets forth a discussion and proposal entitled “Modify Determination of Amounts Subject to Employment or Self-Employment Tax for Partners and S Corporation Shareholders (sec. 1402)” (the JCT Proposal).69

The JCT Proposal notes that the provision in section 1402(a)(13) exempting the distributive share of limited partners from being treated as NESE reflects state law at the time it was enacted in 1977, when limited partners ordinarily were not allowed to participate in management of the partnership. The JCT Proposal also notes, as discussed previously,70 that that distinction between general partners and limited partners is no longer valid for tax purposes because many states now permit limited partners to participate in management of the partnership without jeopardizing their limited liability status.71

The JCT Proposal also describes LLC members as neither general partners nor limited partners and describes the efforts under the 1997 Proposed Regulations to draft a rule that fits LLC members into the statutory framework of general partners and limited partners.

The employment tax treatment of partners who are neither limited nor general partners is uncertain. In particular, owners of a limited liability company may view themselves as comparable to limited partners, even though they are not limited partners under applicable State law. This uncertainty makes compliance with the law difficult for taxpayers and administration of the law difficult for the IRS. The uncertainty in treatment creates an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument is contrary to the spirit and intent of the employment tax rules. In addition, the increasing ability of individuals who are limited partners under State law to perform services for the partnership suggests that the limited partner rule is out of date and should be changed.72

2. JCT proposal for partnerships. Under the JCT Proposal, the existing statutory rule of section 1402(a) for general partners would generally be applied (through new legislation) to all partners so that all partners, including limited partners, partners in LLPs and LLLPs, and LLC members, would be subject to Self-Employment Tax on their distributive share (whether or not distributed) of all partnership Business Income. This general approach would have the following exceptions:

a. Excluded income items. As is currently the case under section 1402, the JCT Proposal would generally exclude specified types of income or loss from NESE of a partner such as rental income, dividends and interest, and some capital gains. However, in a sharp diversion from existing law applied to partnerships, the JCT Proposal would include Excluded Income in the NESE of all partners in a service partnership (one in which substantially all the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) (a JCT Service Partnership).73

b. Partners who do not materially participate. Any partner (whether a general partner, limited partner, or LLC member, whether or not a manager) who does not materially participate in the trade or business of the partnership would be required to include in his NESE only that partner’s reasonable compensation from the partnership. Regarding the use of the material participation standard, the JCT Proposal states:

66Id. The proposal recommends incorporating the suggested definition of reasonable rate of return into section 1402(a)(13).
67Although the flowchart indicates that a person should consider the Reasonable Compensation Test before the Return on Capital Test, because the two tests are essentially parallel tracks a person can just as easily consider the Return on Capital Test before the Reasonable Compensation Test.
69Id. at 95-104.
70See the discussion in section I.C., supra.
71JCT Report, supra note 68, at 97-98.
72Id. at 98-99.
73In contrast to the definition of a 1997 Proposed Regulations Service Partnership, the definition of JCT Service Partnership includes an entity in which substantially all of the activities include performing arts. See supra note 82.
As a means of further isolating labor income of partners that is subject to self-employment tax, the proposal provides that if a partner does not materially participate in the trade or business of the partnership, only the partner’s reasonable compensation from the partnership is treated as net earnings from self-employment. Material participation is a standard that has been frequently applied since its enactment in 1986 as a component of the passive loss rules (sec. 469). Though it does require a factual inquiry, the standard is well developed in the section 469 regulations.74

3. Flowchart depicting operation of the JCT Proposal. The flowchart on the following page depicts operation of the JCT Proposal in determining NESE of a partner in a partnership.

4. JCT Proposal for S corporations.75 Under the JCT Proposal, an S corporation would be treated as a partnership and all S corporation shareholders would be treated as general partners. Thus, S corporation shareholders would be subject to Self-Employment Tax on their distributive shares of S corporation income (whether or not distributed) and would no longer be subject to employment tax on compensation received from the S corporation. Like the proposal for partnerships, an S corporation

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74JCT Report, supra note 68, at 102.

75On May 25, 2005, J. Russell George, Treasury Inspector General for Tax Administration, testified before the Senate Finance Committee about the employment tax inequities that exist between sole proprietorships and single-shareholder S corporations. In his statement, George noted that in 2000 alone, S corporations paid $5.7 billion less in employment taxes than would have been paid if the taxpayers were sole proprietors. Doc 2005-11534, 2005 TNT 101-88.
shareholder’s distributive share of Excluded Income generally would not be subject to Self-Employment Tax. However, in the case of a service S corporation (defined in the same manner as a JCT Service Partnership), all of an S corporation shareholder’s share of Excluded Income would be treated as NESE.76

5. Application to specific types of business entities.

a. Partnerships (including general partnerships, LLPs, limited partnerships, LLLPs, and LLCs). Under the JCT Proposal, all partners in an entity treated as a partnership for income tax purposes would be treated as general partners. However, the JCT Proposal would result in two significant changes in the current law treatment of general partners.

i. Partners who do not materially participate. Under existing law, the entire distributive share of a general partner (other than Excluded Income) is included in NESE, without regard to the level of participation of the partner. Under the JCT Proposal, a partner who is not a member of a JCT Service Partnership and who does not materially participate in the partnership’s business activities will escape NESE treatment for all of his distributive share of partnership Business Income other than the portion, if any, that represents reasonable compensation.

76In May 2005 TIGTA issued a report to the IRS entitled Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations Doc 2005-11591, 2005 TNT 101-32 (the TIGTA Report). The TIGTA Report includes a memorandum, dated May 20, 2005, from Pamela J. Gardiner, deputy inspector general for audit. Gardiner’s memorandum makes the following recommendation:

To eliminate the employment tax shelter for most S corporations, increase Social Security and Medicare employment tax revenues by $30.8 billion and $30.2 billion respectively between Calendar Years 2006 and 2010, provide for equitable employment tax treatment of taxpayers, and reduce the burden on IRS examination resources, we recommended the IRS Commissioner inform the Assistant Secretary of the Treasury for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was apparently issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders. The IRS Commissioner should consult with Treasury regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through the drafting of new legislation, either of which should subject all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder’s spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.
ii. Service partnerships. A partner in a JCT Service Partnership would be required to include his or her distributive share of Business Income and Excluded Income in NESE, as well as the remainder of his distributive share.

b. S corporations. Under the JCT Proposal, all S corporation shareholders would be treated as general partners subject to the rules described above for partnerships. S corporation shareholders would no longer be subject to employment taxes on any compensation paid to them as employees of the S corporation. An S corporation shareholder’s distributive share of Excluded Income generally would not be subject to Self-Employment Tax. However, in the case of an S corporation that qualified as a JCT Service Partnership (if organized as a partnership), all of an S corporation shareholder’s distributive share of Business Income and Excluded Income would be treated as NESE, as well as the remainder of his distributive share. That result could cause taxpayers to segregate assets generating Excluded Income into another entity to avoid that income from being characterized as NESE.

IV. Hypotheticals — Analysis Under the Proposals

The following hypotheticals present varying fact patterns for purposes of contrasting operation of the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal. Each hypothetical will describe the named individual (Alice, Ben, etc.) who is an owner (partner or member) in the hypothetical entity and then describe the effect (under each of the three sets of proposals) of the following owner/entity scenarios:

1. the owner is a general partner in a general partnership;
2. the owner is a general partner in a limited partnership;
3. the owner is a limited partner in a limited partnership;
4. the owner holds both a general partnership interest and a limited partnership interest in a limited partnership;
5. the owner is a general partner in an LLP;
6. the owner is a limited partner in an LLLP;
7. the owner is a partner in an LLP;
8. the owner is a member in a member-managed LLC;
9. the owner is a member who is also a manager of a manager-managed LLC; and
10. the owner is a nonmanager-member in a manager-managed LLC.

Assumptions: Each hypothetical will also specify the following assumptions.

Participation: Each hypothetical will specify the level of the owner’s participation in the business of the entity and an amount that could be objectively established to be reasonable compensation for the services performed (if any) by that owner.

Capital Investment: Each hypothetical will specify whether the owner has made a significant capital investment in the business as well as the amount of the owner’s unreturned capital as of January 1, 2005. In each hypothetical, it is assumed that a reasonable return on capital for 2005 is 7.15 percent (150 percent of the long-term applicable federal rate for January 2005).

Distributive Share: In each hypothetical, it is assumed that the owner’s distributive share of 2005 Business Income is $300,000 and that the owner’s distributive share of Excluded Income is $25,000. In certain hypotheticals, there is an additional assumption that the owner’s distributive share of Business Income is split between two types of ownership interest.

A. Professional Service Entity Without Employees Or Capital

Alice is an owner in a professional service firm (A Co.) consisting of several owner-professionals and support staff, but no nonowner employee professionals. A. Co. qualifies both as a 1997 Proposed Regulations Service Partnership and a JCT Service Partnership.

Assumptions:

Participation: Alice materially participates in the business affairs of A Co. and performs more than 500 hours of service per year. Reasonable compensation for Alice’s services for 2005 is $300,000.

Capital Investment: Neither Alice nor the other owners of A Co. have made significant capital investments in the firm. Alice’s unreturned capital in A Co. as of January 1, 2005, was $5,000.

1. 1997 Proposed Regulations — analysis. Because Alice is a service partner in a 1997 Proposed Regulations Service Partnership, regardless of whether A Co. is organized as a general partnership, limited partnership, LLLP, LLP, or LLC, she must treat her entire distributive share of Business Income as NESE. The Multiple Class of Interest Exception and the Single Class of Interest Exception do not apply to partners in a 1997 Proposed Regulations Service Partnership.77

NESE: $300,000 distributive share of Business Income, excluding $25,000 distributive share of Excluded Income.

2. Joint ABA/AICPA Proposal — analysis. Because A Co. is a traditional professional service entity with no nonowner professional employees and because Alice has insubstantial invested capital, regardless of whether A Co. is organized as a general partnership, limited partnership, LLLP, LLP, or LLC, Alice will be required to treat her entire distributive share of Business Income as NESE.

NESE: $300,000 distributive share of Business Income, excluding $25,000 distributive share of Excluded Income.

3. JCT Proposal — analysis. Because A Co. is a JCT Service Partnership, regardless of whether A Co. is organized as a general partnership, limited partnership,
LLLP, LLP, or LLC, Alice’s entire distributive share of A Co. income (including Excluded Income\(^78\)) must be treated as NESE.

NESE: $300,000 distributive share of Business Income, plus $25,000 distributive share of Excluded Income.

B. Professional Service Entity With Employees and Capital

Ben is an owner in a professional service firm (B Co.) consisting of 10 owner-professionals and 100 nonowner employed professionals (as well as support staff). B Co. qualifies both as a 1997 Proposed Regulations Service Partnership and a JCT Service Partnership.

**Assumptions:**

- **Participation:** Ben materially participates in the business affairs of B Co. and performs more than 500 hours of service per year. Reasonable compensation for Ben’s services for 2005 is $200,000.
- **Capital Investment:** Ben and the other owners of B Co. have made relatively (for a professional service entity) substantial capital investments in the firm. Ben’s unreturned capital in B Co. as of January 1, 2005, was $400,000.

1. 1997 Proposed Regulations — analysis. Because Ben is a service partner in a 1997 Proposed Regulations Service Partnership, regardless of whether B Co. is organized as a general partnership, limited partnership, LLLP, LLP, or LLC, he must treat his entire distributive share of Business Income as NESE. The Multiple Class of Interest Exception and the Single Class of Interest Exception do not apply to partners in a 1997 Proposed Regulations Service Partnership.\(^79\) Ben’s substantial invested capital in B Co. does not change the result.

NESE: $300,000 distributive share of Business Income, excluding $25,000 distributive share of Excluded Income.

2. Joint ABA/AICPA Proposal — analysis. Under the Joint ABA/AICPA Proposal, regardless of whether B Co. is organized as a general partnership, limited partnership, LLLP, LLP, or LLC, Ben would be required to treat as NESE the lesser of reasonable compensation or the amount of ordinary income in excess of a reasonable return on capital. Ben’s NESE will include only what would constitute reasonable compensation for the services that he renders to B Co.\(^80\) The determination of reasonable compensation should take into account the value of a capital interest in B Co. received by and taxed to Ben. If Ben had received his interest in exchange for services to B Co. and had not contributed any capital to B Co., Ben’s “unreturned capital” should be limited to his share of undistributed income (or possibly zero, if the capital is based exclusively on capital contributions) and NESE would only exclude a reasonable rate of return on such amounts.

NESE: $200,000 under the Reasonable Compensation Test. $271,400\(^81\) under the Return on Capital Test.

Under either test, Ben would exclude his $25,000 distributive share of Excluded Income from NESE.

3. JCT Proposal — analysis. Because B Co. is a JCT Service Partnership, regardless of whether B Co. is organized as a general partnership, limited partnership, LLLP, LLP, or LLC, Ben’s entire distributive share of B Co. income (including Excluded Income) must be treated as NESE.

NESE: $300,000 distributive share of Business Income, plus $25,000 distributive share of Excluded Income.

C. Service Entity With Multiple Owner/Employees

Cheryl is an owner in a firm (C Co.) engaged in personal services that are not traditionally considered professional (that is, C Co. is neither a 1997 Proposed Regulations Service Partnership nor a JCT Service Partnership).

**Assumptions:**

- **Participation:** Cheryl materially participates in the business affairs of C Co. and performs more than 500 hours of service per year. Reasonable compensation for Cheryl’s services for 2005 is $200,000.
- **Capital Investment:** Neither Cheryl nor the other owners of C Co. have made substantial capital investments in the firm. Cheryl’s unreturned capital in C Co. as of January 1, 2005, was $5,000.

1. C Co. as a general partnership.

   a. Treatment under the 1997 Proposed Regulations. Cheryl’s entire distributive share of Business Income would be NESE because Cheryl is a general partner with personal liability for the debts or claims against C Co. and Cheryl has contractual authority to act on behalf of C Co.\(^82\) Because Cheryl and all other co-owners are actively engaged in C Co.’s business, there are no limited partners with a substantial continuing interest in C Co. solely as limited partners. Therefore, neither the Multiple Class of Interest Exception nor the Single Class of Interest Exception applies.

NESE: $300,000 distributive share of Business Income, excluding $25,000 distributive share of Excluded Income.

   b. Treatment under the Joint ABA/AICPA Proposal. Cheryl’s NESE would be the lesser of reasonable compensation paid to Cheryl for services rendered to C Co.

\(^79\)If the JCT Proposal becomes law, sophisticated taxpayers would place assets generating Excluded Income into a separate entity to avoid having that income being characterized as NESE.

\(^78\)Prop. Treas. reg. section 1.1402(a)-2(h)(5).

\(^80\)Presumably, because Ben’s income is derived from other service providers, reasonable compensation would be less than Ben’s entire distributive share. See Pediatric Surgical Assoc., P.C. v. Commissioner, supra note 35 (denying deductions for compensation in a professional medical practice operated as a C corporation).

\(^81\)$300,000 - (7.15 percent x $400,000) = $271,400.

\(^82\)Cheryl has apparent authority to contract on behalf of C Co. even if C Co.’s partnership agreement restricts Cheryl’s actual authority.
determined under the Reasonable Compensation Test\textsuperscript{83} or the amount in excess of a reasonable rate of return on C’s “unreturned capital” determined under the Return on Capital Test.

NESE: $200,000 under the Reasonable Compensation Test. $299,643\textsuperscript{84} under the Return on Capital Test.

Under either test, Cheryl would exclude her $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. Cheryl is subject to the same rule that currently applies under section 1402(a) because Cheryl materially participates in C Co. Cheryl is subject to Self-Employment Tax on her entire distributive share of Business Income.\textsuperscript{85} Because C Co. is not a JCT Service Partnership, Cheryl’s distributive share of Excluded Income is not subject to Self-Employment Tax.

NESE: $300,000, excluding $25,000 of Excluded Income.

2. C Co. as a limited partnership — Cheryl is a general partner.

a. Treatment under the 1997 Proposed Regulations. Cheryl provides more than 500 hours of services in the business of C Co. and has personal liability and apparent authority as a general partner. Thus, she would not be treated as a limited partner under the General Rule of the 1997 Proposed Regulations. The Single Class of Interest Exception cannot apply to Cheryl because she is not excluded from being treated as a limited partner solely by reason of actively performing services.

NESE: $300,000 distributive share of Business Income, excluding $25,000 distributive share of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $299,643\textsuperscript{86} under the Return on Capital Test.

Under either test, Cheryl would exclude her $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

3. C Co. as a limited partnership — Cheryl is a limited partner.

a. Treatment under the 1997 Proposed Regulations. As a limited partner in a limited partnership, Cheryl does not have personal liability for C Co.’s liabilities and does not have apparent authority to contract on behalf of C Co. However, Cheryl is active in C Co.’s business and provides more than 500 hours of personal service for C Co. Accordingly, Cheryl is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception could apply to Cheryl (provided that C Co. has other limited partners who qualify under the General Rule of the 1997 Proposed Regulations) because she is excluded from being treated as a limited partner under the General Rule solely because she performs more than 500 hours of service for C Co. If C Co. has other limited partners who do not actively participate in C Co.’s business, Cheryl would be treated as a limited partner and would exclude from her 2005 NESE her entire distributive share of D Co.’s Business Income and Excluded Income.

NESE: $0.

If Cheryl is the sole limited partner of C Co., or if all the limited partners in C Co. perform more than 500 hours of services, the 1997 Proposed Regulations would treat Cheryl as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $299,643\textsuperscript{87} under the Return on Capital Test.

Under either test, Cheryl would exclude her $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

4. C Co. as a limited partnership — Cheryl is both a general partner and a limited partner.

Further Assumption:

\textit{Distributive Share:} Cheryl’s distributive share of C Co.’s Business Income attributable to her interest as a general partner is $100,000 and her distributive share attributable to her interest as a limited partner is $200,000.

a. Treatment under the 1997 Proposed Regulations. Under the 1997 Proposed Regulations, Cheryl can qualify under the Multiple Class of Interest Exception provided there are other limited partners of C Co. who qualify as limited partners under the General Rule and Cheryl and the other limited partners have the same economic rights regarding their limited partner interests.

\textsuperscript{83}To the extent C’s distributive share of Business Income is attributable to services performed by other co-owners, C’s distributive share may be greater than the amount determined under the Reasonable Compensation Test.

\textsuperscript{84}$300,000 - (7.15\% \times $5,000) = $299,643.$

\textsuperscript{85}If Cheryl did not materially participate in C Co. (that is, she did not satisfy the section 469 material participation test), Cheryl’s NESE would be limited to reasonable compensation.

\textsuperscript{86}See supra note 84.

\textsuperscript{87}See id.
If C Co. has other limited partners who do not actively participate in C Co.’s business, Cheryl would be treated as a limited partner for Self-Employment Tax purposes.

NESE: $100,000, excluding (i) $200,000 income attributable to limited partner interest, and (ii) $25,000 Excluded Income.

If Cheryl is the sole limited partner of C Co., or if all the limited partners in C Co. perform more than 500 hours of service, the Multiple Class of Interest Exception would not apply and the 1997 Proposed Regulations would treat Cheryl as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal.
The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $299,643\(90\) under the Return on Capital Test.

Under either test, Cheryl would exclude her $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Cheryl being a limited partner in a limited partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

6. C Co. as an LLLP — Cheryl is a limited partner.
The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Cheryl being a limited partner in a limited partnership.

7. C Co. as an LLP. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Cheryl being a general partner in an LLLP.

8. C Co. as a Member-Managed LLC.
a. Treatment under the 1997 Proposed Regulations.
As a member in a member-managed LLC, although Cheryl does not have personal liability for C Co.’s liabilities, Cheryl has apparent authority to contract on behalf of C Co. Furthermore, Cheryl is active in C Co.’s business and provides more than 500 hours of personal service for C Co. Accordingly, Cheryl is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception would not apply to Cheryl (even if C Co. has limited partners who do not actively perform services for the partnership) because she is not excluded from being treated as a limited partner under the General Rule solely by reason of her performance of more than 500 hours of service for C Co. (she is also excluded by reason of her apparent authority to contract on behalf of C Co.).\(91\) Therefore, the 1997 Proposed Regulations would treat Cheryl as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal.
The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $299,643\(90\) under the Return on Capital Test.

Under either test, Cheryl would exclude her $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Cheryl being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

9. C Co. as a manager-managed LLC — Cheryl is a manager.
The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint

\(89\)See id.

\(90\)See supra note 84.

\(91\)See id.
ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Cheryl being a general partner in an LLLP.

10. C Co. as a manager-managed LLC — Cheryl is a nonmanager-member. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Cheryl being a limited partner in a limited partnership.

D. Nonservice Entity With Material Participation
And Substantial Capital

Dan is an owner in a retail business firm (D Co.) that has several other co-owners and numerous employees.

Assumptions:

Participation: Dan materially participates in the business affairs of D Co. and performs more than 500 hours of service per year. Reasonable compensation for Dan’s services for 2005 is $200,000.

Capital Investment: Dan and the other owners of D Co. have made substantial capital investments in the firm. Dan’s unreturned capital in D Co. as of January 1, 2005, was $400,000.

1. D Co. as a general partnership.

a. Treatment under the 1997 proposed regulations. As a general partner in a general partnership, Dan has personal liability for D Co.’s liabilities and has apparent authority92 to contract on behalf of D Co. Furthermore, Dan is active in D Co.’s business and provides more than 500 hours of personal service for D Co. Accordingly, the 1997 Proposed Regulations do not treat Dan as a limited partner. Because D Co. is a general partnership, it has no limited partners and therefore neither the Multiple Class of Interest Exception nor the Single Class of Interest Exception applies.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal.

Even though Dan is a general partner in D Co., the Joint ABA/AICPA Proposal would allow Dan to exclude from NESE the portion of his distributive share of D Co.’s Business Income that constitutes a reasonable return on his unreturned capital.

NESE: $200,000 under the Reasonable Compensation Test. $271,40093 under the Return on Capital Test.

Under either test, Dan would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. As a partner who materially participates in a partnership that is not a JCT Service Partnership, Dan would include in NESE his entire distributive share of D Co.’s Business Income and would exclude his distributive share of D Co.’s Excluded Income.

2. D Co. as a limited partnership — Dan is a general partner.

a. Treatment under the 1997 Proposed Regulations. As a general partner in a limited partnership, Dan has personal liability for D Co.’s liabilities and has apparent authority to contract on behalf of D Co. Furthermore, Dan is active in D Co.’s business and provides more than 500 hours of personal service for D Co. Accordingly, the 1997 Proposed Regulations do not treat Dan as a limited partner.

The Single Class of Interest Exception does not apply to Dan because he is not excluded from being treated as a limited partner under the General Rule of the 1997 Proposed Regulations solely by reason of his performance of more than 500 hours of service for D Co.94 Therefore, Dan is treated as a general partner under the 1997 Proposed Regulations.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal.

The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $271,40095 under the Return on Capital Test.

Under either test, Dan would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

3. D Co. as a limited partnership — Dan is a limited partner.

a. Treatment under the 1997 Proposed Regulations. As a limited partner in a limited partnership, Dan does not have personal liability for D Co.’s liabilities and does not have apparent authority to contract on behalf of D Co. However, Dan is active in D Co.’s business and provides more than 500 hours of personal service for D Co. Accordingly, Dan is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception could apply to Dan (provided D Co. has other limited partners who qualify under the General Rule of the 1997 Proposed Regulations) because he is excluded from being treated as a limited partner under the General Rule solely because he performs more than 500 hours of service for D Co. If D Co. has other limited partners who do not actively participate in D Co.’s business, Dan would be treated as

92Dan has apparent authority to contract on behalf of D Co. even if D Co.’s partnership agreement restricts Dan’s actual authority.

93$300,000 - (7.15 percent x $400,000) = $271,400.

94Dan is excluded from being treated as a limited partner by reason of his personal liability for D Co.’s debts and his apparent authority to contract on behalf of D Co.

95See supra note 93.
a limited partner and would exclude from his 2005 NESE his entire distributive share of D Co.’s Business Income and Excluded Income.

NESE: $0.

If Dan is the sole limited partner of D Co., or if all the limited partners in D Co. perform more than 500 hours of services, the 1997 Proposed Regulations would treat Dan as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $271,40098 under the Return on Capital Test.

Under either test, Dan would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

4. D Co. as a limited partnership — Dan is both a general partner and a limited partner.

Further Assumption:

Distributive Share: Dan’s distributive share of D Co.’s Business Income attributable to his interest as a general partner is $100,000 and his distributive share attributable to his interest as a limited partner is $200,000.

a. Treatment under the 1997 Proposed Regulations. Under the 1997 Proposed Regulations, Dan can qualify under the Multiple Class of Interest Exception provided there are other limited partners of D Co. who qualify as limited partners under the General Rule and Dan and the other limited partners have the same economic rights regarding their limited partner interests.

If D Co. has other limited partners who do not actively participate in D Co.’s business, Dan would be treated as a limited partner for NESE purposes and would exclude from NESE the portion of his distributive share of Business Income attributable to his interest as a limited partner as well as his share of Excluded Income.

NESE: $100,000, excluding (i) $200,000 income attributable to limited partner interest, and (ii) $25,000 Excluded Income.

If Dan is the sole limited partner of D Co., or if all the limited partners in D Co. perform more than 500 hours of services, the Multiple Class of Interest Exception would not apply and the 1997 Proposed Regulations would treat Dan as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $271,40099 under the Return on Capital Test.

Under either test, Dan would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

5. D Co. as an LLLP — Dan is a general partner.

a. Treatment under the 1997 Proposed Regulations. As a general partner in a state law LLLP, although Dan does not have personal liability for D Co.’s liabilities, Dan does have apparent authority to contract on behalf of D Co. Furthermore, Dan is active in D Co.’s business and provides more than 500 hours of personal service for D Co. Accordingly, Dan is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception would not apply to Dan (even if D Co. has limited partners who do not actively perform services for the partnership) because he is not excluded from being treated as a limited partner under the General Rule solely by reason of his performance of more than 500 hours of service for D Co. (he is also excluded by reason of his apparent authority to contract on behalf of D Co.).99 Therefore the 1997 Proposed Regulations would treat Dan as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $271,40099 under the Return on Capital Test.

Under either test, Dan would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

6. D Co. as an LLLP — Dan is a limited partner.

The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Dan being a limited partner in a limited partnership.

7. D Co. as an LLP. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations,
the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Dan being a general partner in an LLLP.

8. D Co. as a member-managed LLC.

   a. Treatment under the 1997 Proposed Regulations. As a member in a member-managed LLC, although Dan does not have personal liability for D Co.’s liabilities, Dan has apparent authority to contract on behalf of D Co. Furthermore, Dan is active in D Co.’s business and provides more than 500 hours of personal service for D Co. Accordingly, Dan is not a limited partner under the General Rule of the 1997 Proposed Regulations.

   The Single Class of Interest Exception would not apply to Dan because he is not excluded from being treated as a limited partner under the General Rule solely by reason of his performance of more than 500 hours of service for D Co. Therefore, the 1997 Proposed Regulations would treat Dan as a general partner.

   NESE: $300,000, excluding $25,000 of Excluded Income.

   b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

   NESE: $200,000 under the Reasonable Compensation Test. $271,400\(^\text{100}\) under the Return on Capital Test.

   Under either test, Dan would exclude his $25,000 distributive share of Excluded Income from NESE.

   c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Dan being a general partner in a general partnership.

   NESE: $300,000, excluding $25,000 of Excluded Income.

9. D Co. as a manager-managed LLC — Dan is a manager. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Dan being a general partner in an LLLP.

10. D Co. as a manager-managed LLC — Dan is a nonmanager-member. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Dan being a limited partner in a limited partnership.

E. Nonservice Entity Without Material Participation but With Substantial Capital

Ethyl is an owner-investor in a retail business firm (E Co.) that has several other co-owners (some of which are active in the firm’s business) and numerous employees.

Assumptions:

   Participation: Ethyl does not materially participate in the business affairs of E Co. and performs no services. Reasonable compensation for Ethyl’s services for 2005 is $0.

   Capital Investment: Ethyl and several other owners of E Co. have made substantial capital investments in the firm. Ethyl’s unreturned capital in E Co. as of January 1, 2005, was $400,000.

1. E Co. as a general partnership.

   a. Treatment under the 1997 Proposed Regulations. Ethyl is not treated as a limited partner under the General Rule of the 1997 Proposed Regulations because she has personal liability for E Co.’s liabilities and has apparent authority to contract on behalf of E Co. The Single Class of Interest Exception does not apply because Ethyl fails the General Rule for reasons other than participating in E Co.’s business for more than 500 hours per year. Therefore, the 1997 Proposed Regulations treat Ethyl as a general partner despite her purely passive role.

   NESE: $300,000, excluding $25,000 of Excluded Income.

   b. Treatment under the Joint ABA/AICPA Proposal. Because Ethyl does not perform any services for E Co., none of her distributive share of Business Income (and none of her distributive share of Excluded Income) would be treated as NESE. The fact that Ethyl invested substantial capital in E Co. is irrelevant to the analysis because the Reasonable Compensation Test and the Return on Capital Test can only apply if Ethyl performs services for E Co. (that is, Ethyl would not be entitled to compensation unless she performs services).

   NESE: $0.

   c. Treatment under the JCT Proposal. Because E Co. is not a JCT Service Partnership and Ethyl does not materially participate in E Co.’s business, Ethyl would only have NESE to the extent of reasonable compensation. However, because Ethyl does not perform any services for E Co., no part of her distributive share of Business Income or Excluded Income should be treated as NESE.\(^\text{101}\)

   NESE: $0.

2. E Co. as a limited partnership — Ethyl is a general partner. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Ethyl being a general partner in a general partnership.

3. E Co. as a limited partnership — Ethyl is a limited partner.

   a. Treatment under the 1997 Proposed Regulations. Ethyl is treated as a limited partner under the General Rule of the 1997 Proposed Regulations because she does not (i) have personal liability for E Co.’s liabilities, (ii) have apparent authority to contract on behalf of E Co., or (iii) participate in E Co.’s business.

   NESE: $0.

\(^\text{100}\) See id.

\(^\text{101}\) If Ethyl did perform services for E Co. but did not materially participate in E Co.’s business, the reasonable compensation approach under the JCT Proposal could cause Ethyl’s distributive share of Excluded Income to be characterized as NESE to the extent reasonable compensation for Ethyl’s services exceeded her distributive share of Business Income.
b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

4. E Co. as a limited partnership — Ethyl is both a general partner and a limited partner.

Further Assumption:

* Distributive Share: Ethyl's distributive share of E Co.'s Business Income attributable to her interest as a general partner is $100,000, and her distributive share attributable to her interest as a limited partner is $200,000. 

a. Treatment under the 1997 Proposed Regulations. Ethyl is not treated as a limited partner under the General Rule of the 1997 Proposed Regulations because she has personal liability for E Co.'s liabilities and has apparent authority to contract on behalf of E Co. The Multiple Class of Interest Exception could apply if (i) other co-owners in E Co. who qualify as limited partners under the General Rule own a substantial continuing interest solely as limited partners in E Co., and (ii) Ethyl's rights and obligations as a limited partner are identical to the rights and obligations of those other co-owners. If the Multiple Class of Interest Exception applies, all of Ethyl's distributive share of Business Income attributable to her general partner interest, but none of her distributive share of Business Income attributable to her limited partner interest, would be treated as NESE.

NESE: $100,000, excluding (i) $200,000 income attributable to limited partner interest, and (ii) $25,000 Excluded Income.

If the Multiple Class of Interest Exception does not apply, all of Ethyl's distributive share of Business Income attributable to her general partner and limited partner interests would be treated as NESE. In no event would Ethyl's distributive share of Excluded Income be treated as NESE.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

5. E Co. as an LLLP — Ethyl is a general partner.

a. Treatment under the 1997 Proposed Regulations. Even though Ethyl does not have personal liability for E Co.'s liabilities, she is not treated as a limited partner under the General Rule of the 1997 Proposed Regulations because she has apparent authority to contract on behalf of E Co. The Single Class of Interest Exception does not apply because Ethyl fails the General Rule for reasons other than participating in E Co.'s business for more than 500 hours per year. All of Ethyl's distributive share of Business Income (but none of her distributive share of Excluded Income) would be treated as NESE.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

6. E Co. as an LLLP — Ethyl is a limited partner. The analysis and result are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Ethyl being a general partner in a limited partnership.

7. E Co. as an LLP. The analysis and result are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Ethyl being a general partner in an LLP.

8. E Co. as a member-managed LLC.

a. Treatment under the 1997 Proposed Regulations. As a member in a member-managed LLC, although Ethyl does not have personal liability for E Co.'s liabilities and does not materially participate in E Co.'s business, Ethyl has apparent authority to contract on behalf of E Co. Accordingly, Ethyl is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception would not apply to Ethyl because she is not excluded from being treated as a limited partner under the General Rule solely by reason of her performance of more than 500 hours of service for E Co. Therefore, the 1997 Proposed Regulations would treat Ethyl as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Ethyl being a general partner in a general partnership.

NESE: $0.

9. E Co. as a manager-managed LLC — Ethyl is a manager. The analysis and result are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Ethyl being a general partner in an LLLP.

10. E Co. as a manager-managed LLC — Ethyl is a nonmanager-member. The analysis and result are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Ethyl being a limited partner in a limited partnership.
F. Nonservice Entity With Profits Interest and Substantial Capital

Fred is an owner-investor in a retail business firm (F Co.) that has several other co-owners and numerous employees. Fred has not made any capital investment in F Co. and received his ownership interest in exchange for his services for the firm. Fred works full-time for F Co. The other owners of F Co. have made substantial capital investments in the firm. Over time, Fred’s capital account has grown as a result of allocations of firm profits in excess of distributions to Fred.

Assumptions:
Participation: Fred materially participates in the business affairs of F Co. and performs more than 500 hours of service per year. Reasonable compensation for Fred’s services for 2005 is $200,000.
Capital Investment: Fred has not made any capital investments in the firm. As a result of allocations of F Co. income to Fred that have not been distributed to Fred, his capital account as of January 1, 2005, was $50,000.

1. F Co. as a general partnership.
a. Treatment under the 1997 Proposed Regulations.
As a general partner in a general partnership, Fred has personal liability for F Co.’s liabilities and has apparent authority to contract on behalf of F Co. Furthermore, Fred is active in F Co.’s business and provides more than 500 hours of personal service for F Co. Accordingly, the 1997 Proposed Regulations do not treat Fred as a limited partner. Because F Co. is a general partnership, it has no limited partners and therefore neither the Multiple Class of Interest Exception nor the Single Class of Interest Exception applies.
NESE: $300,000, excluding $25,000 of Excluded Income.
b. Treatment under the Joint ABA/AICPA Proposal.
Even though Fred is a general partner in F Co., the Joint ABA/AICPA Proposal would allow Fred to exclude from NESE the portion of his distributive share of F Co.’s Business Income that constitutes a reasonable return on his unreturned capital.

i. The Reasonable Compensation Test. Fred’s NESE from F Co. will include only what would constitute reasonable compensation for the services that he renders to F Co.102
NESE: $200,000, excluding $25,000 of Excluded Income.

ii. Safe Harbor Test — Reasonable Rate of Return Test. Fred received his general partnership interest in exchange for his services to F Co. and has not technically contributed any money or property to it. Thus, Fred’s “unreturned capital” should be limited to his share of undistributed income and his NESE would exclude only a reasonable rate of return on those amounts.
NESE: $296,425,103 excluding $25,000 Excluded Income.

2. F Co. as a limited partnership — Fred is a general partner.
a. Treatment under the 1997 Proposed Regulations.
As a general partner in a limited partnership, Fred has personal liability for F Co.’s liabilities and has apparent authority to contract on behalf of F Co. Furthermore, Fred is active in F Co.’s business and provides more than 500 hours of personal service for F Co. Accordingly, the 1997 Proposed Regulations do not treat Fred as a limited partner.
The Single Class of Interest Exception does not apply to Fred because he is not excluded from being treated as a limited partner under the General Rule of the 1997 Proposed Regulations solely by reason of his performance of more than 500 hours of service for F Co. Therefore, Fred is treated as a general partner under the 1997 Proposed Regulations.
NESE: $300,000, excluding $25,000 of Excluded Income.
b. Treatment under the Joint ABA/AICPA Proposal.
The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.
NESE: $200,000 under the Reasonable Compensation Test. $296,425104 under the Return on Capital Test.
Under either test, Fred would exclude his $25,000 distributive share of Excluded Income from NESE.

However, if Fred received his interest in F Co. for his past services and presumably recognized ordinary income on the receipt, arguably (i) Fred’s contributed capital should include the value of his capital account on the date he received his interest, and (ii) the “unreturned capital” of the other general partners should be adjusted on a pro rata basis to reflect that capital shift. The ABA proposal does not specifically address that issue.
The case is clearer if Fred received his profits interest for future services. In that case, Fred’s unreturned capital would include only his share of undistributed income. That, arguably, would be the case even if, after Fred’s admission to the general partnership, the capital accounts of the general partners were adjusted under Treas. reg. section 1.704-1(b)(2)(iv)(f) on admission of additional general partners to F Co. That is because, under the Joint ABA/AICPA Proposal, increases or decreases to capital accounts resulting from those adjustments are not taken into account in determining “unreturned capital.” Presumably a similar approach would apply in the case of partnership mergers and divisions.

c. Treatment under the JCT Proposal.
Because F Co. is not a JCT Service Partnership and Fred materially participates, all of Fred’s distributive share of Business Income is NESE but none of Fred’s Excluded Income would be treated as NESE.
NESE: $300,000, excluding $25,000 of Excluded Income.

102Query whether the determination of reasonable compensation should take into account the value of a partnership capital interest received and taxed to Fred.
103$300,000 - (7.15 percent x $50,000) = $296,425.
104See id.
c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

3. F Co. as a limited partnership — Fred is a limited partner.

a. Treatment under the 1997 Proposed Regulations. As a limited partner in a limited partnership, Fred does not have personal liability for F Co.’s liabilities and does not have apparent authority to contract on behalf of F Co. However, Fred is active in F Co.’s business and provides more than 500 hours of personal service for F Co. Accordingly, Fred is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception could apply to Fred (provided that F Co. has other limited partners who qualify under the General Rule of the 1997 Proposed Regulations) because he is excluded from being treated as a limited partner under the General Rule solely because he performs more than 500 hours of service for F Co. If F Co. has other limited partners who do not actively participate in F Co.’s business, Fred would be treated as a limited partner and would exclude from his 2005 NESE his entire distributive share of F Co.’s Business Income and Excluded Income.

NESE: $0.

If Fred is the sole limited partner of F Co., or if all the limited partners in F Co. perform more than 500 hours of services, the 1997 Proposed Regulations would treat Fred as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $296,425 under the Return on Capital Test.

Under either test, Fred would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

4. F Co. as a limited partnership — Fred is both a general partner and a limited partner.

Further Assumption: Distributive Share: Fred’s distributive share of F Co.’s Business Income attributable to his interest as a general partner is $100,000, and his distributive share attributable to his interest as a limited partner is $200,000.

a. Treatment under the 1997 Proposed Regulations. Under the 1997 Proposed Regulations, Fred can qualify under the Multiple Class of Interest Exception, provided there are other limited partners of F Co. who qualify as limited partners under the General Rule and Fred and the other limited partners have the same economic rights regarding their limited partner interests.

If F Co. has other limited partners who do not actively participate in F Co.’s business, Fred would be treated as a limited partner for NESE purposes and would exclude from NESE the portion of his distributive share of Business Income attributable to his interest as a limited partner as well as his share of Excluded Income.

NESE: $100,000, excluding (i) $200,000 income attributable to limited partner interest, and (ii) $25,000 Excluded Income.

If Fred is the sole limited partner of F Co., or if all the limited partners in F Co. perform more than 500 hours of services, the Multiple Class of Interest Exception would not apply and the 1997 Proposed Regulations would treat Fred as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $296,425 under the Return on Capital Test.

Under either test, Fred would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

5. F Co. as an LLP — Fred is a general partner.

a. Treatment under the 1997 Proposed Regulations. As a general partner in a state law LLLP, although Fred does not have personal liability for F Co.’s liabilities, Fred does have apparent authority to contract on behalf of F Co. Furthermore, Fred is active in F Co.’s business and provides more than 500 hours of personal service for F Co. Accordingly, Fred is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception would not apply to Fred (even if F Co. has limited partners who do not actively perform services for the partnership) because he is not excluded from being treated as a limited partner under the General Rule solely by reason of his performance of more than 500 hours of service for F Co. (he is also excluded by reason of his apparent authority to contract on behalf of F Co.). Therefore the 1997 Proposed Regulations would treat Fred as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

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105See id.

106See id.

107If Dan was both a general partner and a limited partner in the LLLP, the Multiple Class of Interest Exception could apply.
b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $296,425\(^{108}\) under the Return on Capital Test.

Under either test, Fred would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

6. F Co. as an LLLP — Fred is a limited partner. The analysis and result are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Fred being a limited partner in a limited partnership.

7. F Co. as an LLP. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Fred being a general partner in an LLP.

8. F Co. as a member-managed LLC.

a. Treatment under the 1997 Proposed Regulations. As a member in a member-managed LLC, although Fred does not have personal liability for F Co.'s liabilities, Fred has apparent authority to contract on behalf of F Co. Furthermore, Fred is active in F Co.'s business and provides more than 500 hours of personal service for F Co. Accordingly, Fred is not a limited partner under the General Rule of the 1997 Proposed Regulations.

The Single Class of Interest Exception would not apply to Fred because he is not excluded from being treated as a limited partner under the General Rule solely by reason of his performance of more than 500 hours of service for F Co. Therefore, the 1997 Proposed Regulations would treat F Co. as a general partner.

NESE: $300,000, excluding $25,000 of Excluded Income.

b. Treatment under the Joint ABA/AICPA Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $200,000 under the Reasonable Compensation Test. $296,425\(^{109}\) under the Return on Capital Test.

Under either test, Fred would exclude his $25,000 distributive share of Excluded Income from NESE.

c. Treatment under the JCT Proposal. The analysis and result are the same as discussed above for Fred being a general partner in a general partnership.

NESE: $300,000, excluding $25,000 of Excluded Income.

9. F Co. as a manager-managed LLC — Fred is a manager. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Fred being a general partner in an LLLP.

10. F Co. as a manager-managed LLC — Fred is a nonmanager-member. The analysis and results are the same under all three proposals (the 1997 Proposed Regulations, the Joint ABA/AICPA Proposal, and the JCT Proposal) as discussed above for Fred being a limited partner in a limited partnership.

V. Conclusion

The purposes of this article have been to (i) point out the failure of the existing Self-Employment Tax system as applied to owners of entities treated as partnerships for tax purposes (including state law LLCs, general partnerships, limited partnerships, LLLPs, and other unincorporated entities), (ii) provide guidance to practitioners that will help them understand and comply with the current state of the Self-Employment Tax law applicable to those entities, and (iii) discuss and analyze the possible alternatives presented in recent years. We briefly noted the employment tax issues that are in the S corporation area and the JCT Proposal’s suggestions for conforming tax treatment of S corporation shareholder-employees to the treatment of tax partners, but we have not fully explored that area. Also, we have not dealt with the employment tax issues of the sole proprietor. We are aware of the differences in the historical and current treatment of S corporation shareholders and sole proprietors on one hand and tax partners on the other, but we believe those matters are better left for discussion and analysis elsewhere.

We have attempted to provide information that will enable tax advisers to provide better, informed advice regarding the application of the Self-Employment Tax to partners under current circumstances. After much discussion, we have concluded that, in the current situation, advisers should be able to rely on the existing statutory language of section 1402(a) when determining how the current rules apply to state law general and limited partners. We further have concluded that members of LLCs should be permitted to rely on and use the standards and rules set out in the 1997 Proposed Regulations.

Tax advisers, however, should always consider other tax issues in addition to the Self-Employment Tax when considering the use of any partnership or LLC as the preferred form of ownership.

The foregoing history, discussion, and analysis indicate that the existing regime for taxing a partner’s allocable share of partnership income or loss for Self-Employment Tax purposes is inappropriate. Not only are the rules unclear and their application uncertain, but the apparent loss of legitimate tax revenue is disturbing, if not alarming.\(^{110}\)

\(^{108}\)See supra note 103.

\(^{109}\)See id.

\(^{110}\)See the JCT Report, supra note 68. See also supra notes 75 and 76.
COMMENTARY / SPECIAL REPORT

We have focused on the historical treatment of partners. For a significant period of time, general partners have been required to include in computing NESE their entire share of partnership income and deduction except for Excluded Income. A traditional limited partner’s share of NESE has been limited to an amount, if any, that the partners agree to treat as a guaranteed payment. That dichotomy no longer makes sense.

As of this date, the various proposals to correct the problem have been driven by an attempt to synchronize the business and legal realities with the statutory purpose underlying the Self-Employment Tax. As noted, the 1997 Proposed Regulations were attacked and “frozen” through the Moratorium and, as the foregoing material indicates, those regulations are complicated. The Joint ABA/AICPA proposal is still under consideration, but its two-pronged approach requires a complex application. The JCT proposal is new and skeletal at this time.

Any Self-Employment Tax system applicable to partners should allow for easy administration but use standards or rules that involve only appropriate items of income, and be as fair as possible. Here, that appropriate item is compensation. That is what NESE is, and an ideal world would tax only the compensation income of partners. That is consistent with the underlying purpose of the Self-Employment Tax as applied to partnerships. Members of a subcommittee of the Partnership Committee of the ABA Section of Taxation did discuss revisions to the Joint ABA/AICPA Proposal analyzed here, and those discussions focused on “reasonable compensation” as the appropriate amount of a partner’s NESE. Some considered “reasonable compensation” too uncertain of a standard to apply successfully. However, to simplify the Joint ABA/AICPA Proposal, those considering the matter felt a standard of “reasonable compensation” alone was better than a standard incorporating some exclusion from taxation for a return on capital. Despite the apparent simplicity of the return on capital approach, determining an appropriate rate of return and defining capital are complex questions. However, some provision may be made for the exclusion of a bona fide return on capital.

Given the objectives of simplicity, certainty, and administrable revenue measurement, we have concluded that a proposal incorporating some of the suggestions made by the JCT Proposal best reaches those goals.

The JCT tests are comparatively simple to apply. First, material participation would determine which partners are subject to NESE. The more troubling question of computing reasonable compensation — clearly, the true measure of compensatory income — would be confronted only when a partner does not materially participate. In those cases, after excluding the situations in which a partner provides no services at all and thus has no NESE, the taxpayers and the government can draw on

the common law defining reasonable compensation. The material participation rules of section 469 may need to be modified when applied in that context. Nonetheless, that system would be easier to apply and provide greater certainty than the existing rules.

This two-tier proposal focuses on the compensation element of a partner’s share of partnership income. It allows one standard “material participation” to apply before looking to “reasonable compensation.” That reduces the hardship that may be implicit in applying the latter standard alone.

We do not agree with the JCT Proposal that there be no exclusion for Excluded Income in service partnerships. We believe that even in service partnerships, Excluded Income should remain an excluded item. Even sole proprietors are entitled to compute NESE without considering Excluded Income. Continuing to exclude Excluded Income would be in keeping with the focus on compensation-type income only. Thus, under our proposal, service partners in service partnerships would be treated in the same manner as the partners who materially participate.

Also, each tax partner may be given the opportunity to overcome the presumed correctness of the application of the material participation and reasonable compensation standards by showing his particular facts and circumstances dictate that a portion of his distributive share of income is a return on capital.

Given the fate of proposed changes to section 1402 regulations in the recent past, we have concluded that a regulatory change incorporating our suggestions is highly unlikely. However, given the recent consideration of that issue by the JCT and TIGTA in the context of “tax gap” concerns, as well as the search for a solution to the Social Security issues, this appears to be a propitious time for Congress to consider a proposal dealing with the NESE of tax partners. Not only would it bring simplicity and certainty to a tax issue common to a significant, and growing, number of taxpayers, but it would also apparently raise legitimate revenue.

The authors urge the congressional committees that focus on those issues to consider our suggestion for a statutory change as soon as possible. The authors believe that the interested parties — the taxpaying public, Congress, and the agencies charged with collection of government funds — will find that a solution based on our recommendation provides a fair, more certain, and more administrable system for the taxation of NESE of tax partners.

111 See the discussion at section III.B., supra.
Appendix A

1994 Proposed Regulations*

Is the LLC manager-managed?

YES

Is the member a manager?

YES

Could the LLC have been formed as a limited partnership?

YES

Could the member have qualified as a limited partner?

YES

Does the partner receive guaranteed payments for services?

NO

A. Guaranteed payment for services is NESE
B. Distributive share income is not NESE

NO

All income is NESE

NO

All income is NESE

NO

All income is NESE

YES

All income is NESE

The 1994 Proposed Regulations were withdrawn on January 13, 1997.
Appendix B

AICPA Proposal

Does the member provide services to the partnership?

YES

Are the services performed for more than 100 hours?

NO

May elect for all payments to be NESE

YES

No income is NESE

NO

Do the distributive share and guaranteed payments vary from the Safe Harbor reasonable return on capital?

NO

No income is NESE

YES

Does the member receive guaranteed payments?

NO

A. Only reasonable service portion of variance amount is NESE

YES

B. Safe Harbor amount is not NESE

NO

Is the amount of variance from the Safe Harbor return on capital reasonable?

NO

A. Variance amount is NESE

B. Safe Harbor amount is not NESE

YES

A. General Partner Income is NESE

B. Distributive share is not NESE