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Exploiting the Medicare Tax Loophole

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FLORIDA TAX REVIEW

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Exploiting the Medicare Tax Loophole

by

*Karen C. Burke**

Abstract

Section 1411 imposes a 3.8% surtax on investment income of high earners that mirrors Medicare taxes on earned income. The enactment of the net investment income tax highlights gaps in the employment tax rules for passthrough entities—particularly limited partnerships, S corporations, and limited liability companies. This Article considers how businesses can be structured to allow active high-income owner-employees of passthrough entities to avoid all three of the 3.8% Medicare taxes (SECA, FICA and section 1411). Part I considers the anachronistic limited partner exception to the SECA tax and the well-known S corporation loophole under the FICA tax, as well as the failure of section 1411 to reach active business income that avoids these employment taxes. Part II considers the recent Renkemeyer *case, which has reignited the employment tax debate and threatens to upend structures used in investment and real estate funds to shelter management fees from all of the 3.8% taxes. Although repeal of section 1411 remains high on the Republican tax-cutting agenda, Part III suggests the need to reform (not repeal) section 1411 to backstop the employment tax rules for active passthrough businesses, regardless of organizational form. The proposed approach would curtail opportunities to avoid the 3.8% taxes, raise substantial revenue, and promote the goal of parity in the taxation of earned and unearned income. By contrast, tax legislation enacted in 2017 leaves intact planning to avoid employment taxes and*

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section 1411, while dramatically lowering the income tax rate on business income. As a result, business taxation has grown increasingly incoherent, regressive, and unstable.

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I. INTRODUCTION

During the ill-fated health care debate, the Republican leadership sought to repeal all of the Affordable Care Act ("ACA") taxes[1]—including Code section 1411, which imposes a 3.8% surtax on net investment income ("NII") of high-income earners. Eliminating the net investment income tax ("NIIT") as part of the ACA repeal was intended to lower the revenue baseline in order to make subsequent tax cuts appear to be less costly. The gimmick depended upon not accounting for the substantial revenue loss attributable to repeal of the ACA taxes.[2] Although health

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1. *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010) [hereinafter PPACA]. Code section 1411 was enacted as part of the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a)(1), 124 Stat. 1029, 1060–63.

2. *See* Leonard E. Burman et al., *An Analysis of the House GOP Tax Plan*, 8 COLUM. J. TAX L. 257, 270 (2017); Howard Gleckman, *Yes, Killing the ACA's Investment Tax Now Would Make the Next GOP Tax Bill Easier. Here's Why*, TAX POL'Y CTR.: TAXVOX (July 20, 2017), http://www.taxpolicycenter.org/taxvox/yes-killing-acas-investment-tax-now-would-make-next-gop-tax-bill

care legislation has stalled, repeal of section 1411 remains very much on the agenda. To avoid the political fallout from slashing taxes at the top while simultaneously eliminating health care coverage for low-income individuals, the Republican leadership reluctantly agreed temporarily to shelve repeal of section 1411 until a more propitious moment.[3]

Enacted in 2010 and effective beginning in 2013, section 1411 provides a tax on NII ("Unearned Income Medicare Contribution") that is intended to increase fairness in the taxation of earned and unearned income.[4] Employment taxes on wage income ("FICA"[5]) and

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-easier-heres-why ("And cutting the tax rate in a health bill would lower the revenue baseline, making it possible for backers of a deep rate cut to claim it is less expensive than it really is."). For the estimated revenue loss from repeal of I.R.C. § 1411, see JOINT COMM. ON TAX'N, 115TH CONG., JCX-38-17, ESTIMATED REVENUE EFFECTS OF THE TAX PROVISIONS CONTAINED IN THE "OBAMACARE REPEAL RECONCILIATION ACT OF 2017," A POSSIBLE AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 1628 (2017); Colleen Murphy & Laura Davison, *Hill Briefs: Investment Tax Lurks; BAT Pushback*, DAILY TAX REP. (BNA), July 20, 2017, at G-2.

3. *See* Dylan F. Moroses, *New Senate Healthcare Draft Retains ACA Taxes on Wealthy*, 156 TAX NOTES 281 (July 17, 2017); David van den Berg & Dylan F. Moroses, *Senate Healthcare Bill Could Retain $230 Billion in ACA Taxes*, 2017 TAX NOTES TODAY 133-1 (July 13, 2017); *see also* H. WAYS & MEANS COMM., 114TH CONG., A BETTER WAY: OUR VISION FOR A CONFIDENT AMERICA 16 (June 24, 2016), http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf (House Blueprint urging repeal of ACA taxes). The 2017 tax legislation, popularly known as the Tax Cuts and Jobs Act, leaves I.R.C. § 1411 intact and does not change employment taxes, but new I.R.C. § 199A reduces the income tax rate on qualifying business income. Pub. L. No. 115-97, 131 Stat. 2054 (2017) [hereinafter TCJA].

4. *See* JOINT COMM. ON TAX'N, 111TH CONG., JCX-18-10, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 134–36 (2010). The revenue is not specifically dedicated to the Medicare Trust Fund. The additional Medicare contribution appears in Chapter 2A of the Internal Revenue Code.

5. Employment taxes are imposed under the Federal Insurance Contribution Act ("FICA"). *See* I.R.C. ch. 21. The employer portion of FICA tax consists of two components: (1) old age, survivors, and disability insurance ("OASDI") equal to 6.2% of covered wages up the Social Security wage base, and (2) the Medicare or hospital insurance ("HI") tax equal to 1.45% of uncapped wages. I.R.C. §§ 3101, 3111. The employee portion of the FICA tax is equal to the employer tax.

self-employment taxes on net earnings from self-employment ("SECA"[6]) are generally imposed at the same rate and subject to the same caps, except that the employer and employee are each liable for half of FICA taxes. The FICA and SECA taxes both consist of two components—the Old Age, Survivors, and Disability Insurance component ("OASDI") and the Medicare or hospital insurance component ("FICA-HI" and "SECA-HI").[7] For taxpayers whose earnings equal or exceed the OASDI base ($128,400 for 2018), the excess is subject only to the uncapped hospital insurance tax. For taxable years beginning in 2013, the employee portion of the FICA-HI tax and the corresponding SECA-HI tax is increased by 0.9%, increasing the overall rate of the Medicare tax to 3.8%.[8] To mirror Medicare taxes on earned income, section 1411 imposes a parallel 3.8% tax on unearned income of high-income individuals.[9] The NIIT

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6. Self-employment taxes are imposed under the Self-Employed Contributions Act ("SECA"). *See* I.R.C. ch. 2. Like the FICA tax, the SECA tax consists of two components: (1) the OASDI component levied at 12.4% on self-employment income up to the Social Security wage base, and (2) the HI component levied at 2.9% on all self-employment income. I.R.C. § 1401(a), (b)(1).

7. The cap on the OASDI component is indexed each year according to a statutory formula. The Medicare tax is not capped; thus it applies to all wages and net self-employment income. The convention is to append "HI" when only the Medicare or hospital insurance tax is at issue. *See* Cong. Budget Office, The Taxation of Capital and Labor Through the Self-Employment Tax 6 n.18 (2012) [hereinafter CBO (2012)].

8. *See* I.R.C. §§ 1401(b)(2), 3101; *see also* PPACA, *supra* note 1, § 9015 (amending I.R.C. §§ 1401, 3101). The threshold amount is generally $250,000 for a joint return ($200,000 for a single return); the additional tax is on the combined income of the employee and the employee's spouse. Thus, the combined FICA-HI and SECA-HI tax is 3.8% (2.9% plus 0.9%) for high-income individuals. The additional 0.9% tax is not indexed; over time, a growing proportion of taxpayers will exceed the threshold, causing payroll taxes to rise slightly faster than GDP. *See* 2017 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds 28–29 (2017).

9. For individuals, the 3.8% tax applies to the lesser of NII or modified adjusted gross income in excess of $250,000 ($200,000 for a single return). Investment income is reduced by allowable deductions to arrive at NII. I.R.C. § 1411(c)(1).

expressly targets investment income such as interest, dividends, and capital gains.[10]

Although only one of the three 3.8% taxes (FICA-HI, SECA-HI, or NIIT) can apply to the same income and gain, not all earned and unearned income is subject to at least one of the taxes. The NII base does not include FICA wages and self-employment income taken into account under SECA.[11] The NII base also exempts income and gain from an "Excluded Business," i.e., a trade or business activity (other than a trade or business consisting of trading financial instruments or commodities ("Financial Trading Business")) that is not a section 469 passive activity with respect to the taxpayer.[12] Since most passthrough income is active and is disproportionately concentrated among high-income taxpayers, the section 1411 exemption for Excluded Businesses has important distributional and revenue consequences.[13] The enactment of section 1411

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10. The NIIT generally applies only to income and gain from a trade or business that is a passive activity with respect to the taxpayer (within the meaning of I.R.C. § 469) or a trade or business consisting of trading financial instruments or commodities (a "Financial Trading Business") (as defined in I.R.C. § 475(e)(2)). *See* I.R.C. § 1411(c)(1)(A)(i)–(ii), (c)(2). The IRS has issued lengthy regulations providing guidance on application of the NIIT, although many issues remain unresolved. *See* T.D. 9644, 2013–51 I.R.B. 676.

11. I.R.C. § 1411(c)(6). Under I.R.C. § 1401, self-employment income is gross income derived by an individual from a trade or business (less allowable deductions attributable to the trade or business). Self-employment income does not include certain categories of capital income, such as rentals from real estate, dividends, interest, and gain from sale or exchange of capital assets and other property (unless includible in inventory or held primarily for sale to customers in the ordinary course of the trade or business). *See* I.R.C. § 1402(a)(1)–(3) ("Excluded Income").

12. *See* Jeanne M. Sullivan, *Partners and the 3.8% Taxes: FICA, SECA, NIIT, or Nothing?*, 56 Tax Mgmt. Memorandum 377 (Oct. 5, 2015) (defining "excluded business"). By definition, income and gain from an Excluded Business are not subject to any of the three 3.8% taxes; the I.R.C. § 1411 tax is the "last" of the three 3.8% taxes. *See* Sullivan, *supra*.

13. *See* Matthew Smith et al., *Capitalists in the Twenty-First Century* 15 (Nov. 15, 2017), http://faculty.chicagobooth.edu/owen.zidar/research/papers/capitalists.pdf (noting that 91% of the top 1–0.1% of S corporation owners and 94% of the top 0.1% of S corporation owners reported earning active income). Between 1980 and 2013, the income share of the top 1% more than doubled (from 10.0% to 20.1%); 41% of that increase arose from higher

makes more urgent reform of the employment tax rules applicable to tax-transparent limited liability entities that combine passthrough taxation and limited liability with the ability of their members to actively participate in the entity's business operations.[14] Employment tax gaps permit high-income owner-employees to structure Excluded Businesses—often using multiple tiers of state-law partnerships, S corporations, and limited liability companies ("LLCs")—to avoid all three of the 3.8% taxes.[15] Since the late 1990s, the employment tax holiday for passthrough owners has persisted largely thanks to congressional action limiting Treasury's authority to clarify the employment tax status of limited partners and LLC members.[16] Beginning in 2013, the section 1411 tax provided

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passthrough business income. *See* Michael Cooper et al., *Business in the United States: Who Owns It, and How Much Tax Do They Pay?*, 30 Tax Pol'y & Econ. 91, 92 (2016).

14. See Erik Röder, *Combining Limited Liability and Transparent Taxation: Lessons from the Convergent Evolution of GmbH & Co. KGs, S Corporations, LLCs, and Other Functionally Equivalent Entities*, 21 Fla. Tax Rev. (forthcoming 2018). This article does not consider the analogous problem of avoidance of I.R.C. § 1411 if a trust holds business property (e.g., a family real estate business) and the trustee is deemed to materially participate in the business, potentially converting otherwise passive income of the beneficiaries into active income. *See* Frank Aragona Trust v. Comm'r, 142 T.C. 165 (2014).

15. A prime example of such elaborate structuring was revealed in the ownership structure of Chicago's Trump International Hotel & Tower. Lynnley Browning & John McCormick, *Trump's Web of Companies May Have a Way to Avoid the Obamacare Tax*, Bloomberg Businessweek (Aug. 10, 2017, 4:00 AM), https://www.bloomberg.com/news/articles/2017-08-10/trump-s-web-of-companies-may-have-a-way-to-avoid-the-obamacare-tax; *see also* Fred T. Goldberg Jr., & Michael J. Graetz, *Trump Probably Avoided His Medicare Taxes, Too*, N.Y. Times (Nov. 2, 2016), https://www.nytimes.com/2016/11/03/opinion/trump-probably-avoided-his-medicare-taxes-too.html.

16. In 1997, the Treasury issued proposed regulations defining a limited partner for purposes of I.R.C. § 1401. Under the proposed regulations, the limited partner exception would not apply to an individual who participates in the business for more than 500 hours during the taxable year. *See* Prop. Reg. § 1.1402(a)–2, 62 Fed. Reg. 1702, 1703–05 (Jan. 13, 1997). Congress imposed a moratorium, however, on regulations defining a limited partner for purposes of the employment tax rules. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 778, 882. Although the one-year moratorium

an additional incentive for high-income earners to recharacterize income from trade-or-business sources as active rather than passive.

This Article considers how passthrough entities can be structured to avoid all three of the 3.8% taxes and recommends reform (not repeal) of section 1411 to address the revenue loss and inequity resulting from such structuring.[17] Part I considers the anachronistic "limited partner" exception and the well-known S corporation loophole that permit active, high-income passthrough owners to avoid exposure to SECA and FICA taxes and, more recently, the section 1411 tax on unearned income. Part II considers a recent Tax Court decision[18] that has reignited the employment tax debate and, by implication, threatens to upend typical structures used to avoid all of the 3.8% taxes on management fees for services provided to investment and real estate funds. While rationalizing employment tax rules for passthroughs remains a worthwhile objective, Part III suggests a different approach: expanding the base of the NIIT to include active passthrough income and gain that would otherwise escape FICA and SECA taxes. This approach would ensure that high-income owner-employees could no longer avoid contributing to Medicare financing, thereby treating earned and unearned income more equally.

II. Active Limited Partners and S Shareholders

Consistent with imposing a surcharge on passive investment income, section 1411 carves out an exception for most types of active business income. When Congress enacted section 1411, it clearly understood that income and gain from active passthrough businesses could potentially fall outside all three of the 3.8% taxes. Under section 1402(a)(13),

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expired on July 1, 1998, the 1997 Proposed Regulations were never withdrawn or adopted.

17. David C. Culpepper et al., *Self-Employment Taxes and Passthrough Entities: Where Are We Now?*, 109 Tax Notes 211, 235 (Oct. 10, 2005) ("Not only are the rules unclear and their application uncertain, but the apparent loss of legitimate tax revenue is disturbing, if not alarming.").

18. *See* Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C. 137 (2011); *see also* Amy S. Elliott, Renkemeyer *Could Reignite Entity-Employment Tax Debate*, 130 Tax Notes 1244 (Mar. 14, 2011); Martin A. Sullivan, *Economic Analysis:* Renkemeyer *Annual Cost to Partners Could Exceed $1 Billion*, 130 Tax Notes 1386 (Mar. 21, 2011).

state-law limited partners are exempt from SECA, except to the extent that they receive section 707(c) guaranteed payments for services.[19] Unlike partners, S corporation shareholders are not treated as self-employed but rather as employees of the S corporation. As such, they are subject to FICA taxes on wages paid by the S corporation to the extent of reasonable compensation, but not on amounts received in the form of dividends.

A. Active State-Law Limited Partners

General partners and sole proprietors have traditionally been subject to SECA on their net business income, except for clearly identifiable categories of capital income.[20] Prior to 1977, section 1402 did not distinguish between general and limited partners for employment tax purposes, regardless of services performed.[21] In 1977, Congress amended the statute to create an exception, under current section 1402(a)(13), for limited partners who are passive investors.[22] In the 1970s, limited partner interests were marketed to passive investors who paid SECA tax on their distributive shares, thereby qualifying for Social Security benefits. These arrangements offered passive investors an unwarranted tax benefit at the expense of the overall Social Security system, giving rise to "issues of

19. *See* Reg. § 1.707–1(c).

20. *See* I.R.C. § 1402(a)(1)–(3). SECA-exempt income such as interest, dividends, rents, and capital gains will be subject to I.R.C. § 1411 unless derived in the ordinary course of a trade or business. *See* I.R.C. § 1411(c)(1)–(2). Such income is treated as "portfolio income" for purposes of I.R.C. § 469 and thus cannot qualify as nonpassive for purposes of I.R.C. § 1411. *See* Temp. Reg. § 1.469–2T(c)(3)(i).

21. The only exception was for certain retirement payments to retired partners who performed no services. *See* I.R.C. § 1402(a)(10); *see also* Social Security Amendments of 1967, Pub. L. No. 90-248, § 118(a)(3), 81 Stat. 821, 841 (1967) (adding § 1402(a)(10)).

22. Section 1402(a)(13) of the Code was enacted as part of the Social Security Amendments of 1977, Pub. L. No. 95-216, § 313(b), 91 Stat. 1509, 1536. The amendment was intended to "exclude for coverage purposes certain earnings [of limited partners] which are basically of an investment nature." H.R. Rep. No. 95-702, pt. 1, at 11 (1977) [hereinafter H.R. Rep. No. 95-702]. Congress was concerned that "certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits." *Id.* at 40–41.

tax morale and public perception."[23] Benefit eligibility based on investment income was "inconsistent with the basic principle of the [S]ocial [S]ecurity program that benefits are designed to partially replace lost earnings from work."[24] Congress responded by excluding a limited partner's distributive share from SECA tax, except for section 707(c) guaranteed payments for services actually performed.[25]

The statutory reference to "limited partner" was intended to serve as a proxy for passive investors, reflecting state-law restrictions that generally prevented a limited partner from actively participating in management of a partnership's business without losing limited liability. Subsequently, state laws were liberalized to remove constraints on active limited partners, a development that paralleled the emergence of LLCs in the late 1980s.[26] These developments created uncertainty concerning the meaning of the term "limited partner" for purposes of the SECA rules. Moreover, by the mid-1990s high-income earners no longer considered accrual of Social Security benefits to outweigh the associated tax cost, prompting a backlash particularly against the uncapped Medicare component of SECA taxes.[27] Prior to 1983, the SECA tax rate was

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23. David W. Mayo & Rebecca C. Freeland, *Delimiting Limited Partners: Self Employment Tax of Limited Partners*, 66 Tax Law. 391, 393 (2013); *see* Estate of Ellsasser v. Comm'r, 61 T.C. 241 (1973) (passive limited partner in stock brokerage firm subject to self-employment tax on distributive share).

24. H.R. Rep. No. 95-702, *supra* note 22, at 41.

25. The exception was apparently intended to force partnerships to make guaranteed payments to limited partners for services actually performed. N.Y. State Bar Ass'n Tax Section, *Comments on the Application of Employment Taxes to Partners and on the Interaction of the Section 1401 Tax with the New Section 1411*, at 25 (2011), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2011/1247_report.html [hereinafter NYSBA 2011 Comments].

26. *See, e.g.*, Unif. Ltd. P'ship Act § 303 (Nat'l Conference of Comm'rs on Unif. State Laws 2001) (limited partner who participates in management and control of the partnership does not lose limited liability).

27. Following enactment of Medicare in 1965, employment and self-employment taxes were increased to include contributions to the hospital insurance taxes (FICA-HI and SECA-HI). *See* Patricia E. Dilley, *Breaking the Glass Slipper: Reflections on the Self-Employment Tax*, 54 Tax Law. 65, 73–74 (2000) ("Inevitably, perhaps, the current resistance to . . . [SECA taxes] is driven to a large extent by the increase in tax rates for both FICA and

deliberately set lower than the FICA tax rate; in 1990, parity was established between the SECA and FICA tax rates.[28] In 1993, Congress lifted the cap on the FICA-HI and SECA-HI components of payroll taxes, so that the 2.9% Medicare levy now applies without limitation to all types of income included in the FICA and SECA bases.[29] Uncapping of the Medicare tax gave high-income owner-employees a powerful incentive to opt out of the system of mandatory contributions for social insurance.[30]

The employment tax revolt by high earners coincided with an increase in the share of business income earned by passthroughs. Following the 1986 Act's temporary rate inversion, passthroughs gained in popularity at the expense of C corporations, so that, by 2013, 60% of all business net income was taxed only through the personal income tax.[31]

SECA, and the perceived decrease in the value of Social Security benefits for this group.").

28. *See* Joint Comm. on Tax'n, 112th Cong., JCX-36-11, Description of the Social Security Tax Base 4 (2011) [hereinafter JCX-36-11]. Since 1990, only 92.35% of NESE is taxable, i.e., the tax base is reduced by 7.65% to reflect the employer's share of FICA taxes. In addition, self-employed individuals are allowed to deduct half of SECA taxes paid, mirroring the treatment for employees who do not pay income tax on the employer's portion of FICA taxes. *Id.* A self-employed individual's net earnings are "economically equivalent to an employee's wages plus the employer share of FICA taxes." *Id.* at 21. The additional 0.9% tax, under I.R.C. § 1411, is not deductible. I.R.C. § 164(f)(1).

29. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13207, 107 Stat. 312, 467–69 (1993). In addition, half of OASDI benefits (in excess of a threshold) are subject to income tax; since 1993, a second tier of OASDI benefits is includible (up to a maximum of 85%). *See* JCX-36-11, *supra* note 28, at 5.

30. *See* Dilley, *supra* note 27, at 79 (referring to "increasing tax rates" and "disappearing tax ceiling"); *see also* John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie but the Numbers Never Do,"* 78 Tex. L. Rev. 885, 930 (2000) (suggesting that a principal motivation for choosing passthrough treatment is employment tax avoidance).

31. *See* Joint Comm. on Tax'n, 115th Cong., JCX-42-17, Present Law and Data Related to the Taxation of Business Income 46 (2017) [hereinafter JCX-42-17] (for 2013, partnerships accounted for 25.6%, S corporations for 14.9%, REITs and RICs for 10.7%, and nonfarm sole proprietorships for 10.1% of business net income); *see also* George A. Plesko & Eric J. Toder, *Changes in the Organization of Business Activity and Implications for Tax*

While many passthroughs are small businesses, there is a substantial and growing percentage of large passthrough businesses.[32] In the post-1986 low income-tax rate environment, employment taxes loomed large as a percentage of overall taxes. Although employment taxes represent an increasingly important revenue source—accounting for roughly one-third of all federal tax revenue in 2015[33]—aggressive passthrough planning for high earners and rising wage inequality have contributed to erosion of the Social Security tax base.[34] In response to uncertainty concerning the employment tax status of rapidly evolving business forms,

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Reform, 66 Nat'l Tax J. 855, 868 (2013). "Between 1980 and 2012, the C corporation share of net business income fell from 80 percent to less than 48 percent," while the partnership share of net business income rose from less than 3% to 26%. Jason DeBacker & Richard Prisinzano, *The Rise of Partnerships*, 147 Tax Notes 1563, 1564–65 (June 29, 2015); *see also* Cooper et al., *supra* note 13, at 95–96 (concluding that, if partnership activities had remained at the low 1980s level, corporate tax revenue would have been $100 billion higher in 2011); Eric Toder, *Filling the Gap: Pass-Through Businesses and Tax Reform*, Milken Inst. Rev., 1st Quarter 2017, at 37, 39 (passthrough entities accounted for 95% of all business returns in 2012).

32. *See* Toder, *supra* note 31, at 39 ("In 2012, S corporations with gross receipts of $50 million or more accounted for 29 percent of total passthrough profits, while partnerships with total assets of $100 million or more accounted for fully half of partnership profits."); Joint Comm. on Tax'n, 114th Cong., JCX-35-16, Background on Business Tax Reform 22 (2016) (noting that partnerships with total receipts over $50 million represent 0.25% of all partnerships but report 72% of all partnership receipts; similarly, S corporations with total receipts over $50 million represent 0.37% of S corporations but report almost 40% of all S corporation receipts).

33. Cong. Budget Office, The 2015 Long-Term Budget Outlook 25 (2015); *see also* Andrew Mitrusi & James Poterba, *The Changing Importance of Income and Payroll Taxes on U.S. Families*, 15 Tax Pol'y & Econ. 95, 101 (2001) (payroll taxes exceed income taxes for roughly two thirds of all families). When SECA was enacted in 1950, FICA taxes were 5% of federal revenue; SECA taxes account for a much smaller share of revenue (roughly 2% in 2011). *See* CBO (2012), *supra* note 7, at 1.

34. *See* Patricia E. Dilley, *Through the Doughnut Hole: Reimagining the Social Security Contribution and Benefit Base Limit*, 62 Admin. L. Rev. 367, 392–393 (2010); Thomas L. Hungerford, *Broadening the Social Security Tax Base: Issues and Options*, 151 Tax Notes 1391, 1396 (June 6, 2016) (noting decline in ratio of Social Security tax base to all covered payroll between 1983 and 2013). *See generally* Kathleen Romig, *Increasing Payroll Taxes Would*

the IRS proposed regulations, in 1994 and again in 1997, that sought to clarify the outmoded limited partner exception.[35] Predictably, the proposed regulations met a firestorm of political opposition, even though they were largely beneficial to passthroughs.[36]

> *Example (1)*: Individual *A* owns a limited partner interest in *P*, a state-law limited partnership, and works full-time in *P*'s business. In 2017, *A*'s distributive share of *P*'s income is $450,000, and *A* also receives a section 707(c) guaranteed payment of $50,000 for services. *A* "materially participates" in *P*'s business.[37] Under the literal language of section 1402(a)(13), *A*'s entire distributive share is apparently exempt from the SECA tax. *A*'s guaranteed payment for services is subject to SECA; since a partner cannot be an employee of a partnership, no portion of *A*'s distributive share is taxed under FICA.[38] Given *A*'s active status, *A*'s distributive share is apparently exempt from section 1411.[39] If *A* sells her partnership interest, *A*'s gain on sale of the interest will also be exempt under both section 1411 and SECA.[40]

Strengthen Social Security, CTR. ON BUDGET & POL'Y PRIORITIES (Sept. 27, 2016), https://www.cbpp.org/sites/default/files/atoms/files/9-27-16socsec.pdf.

35. *See* Prop. Reg. § 1.1402(a)–2, 62 Fed. Reg. 1702, 1703–05 (Jan. 13, 1997); Prop. Reg. § 1.1402(a)–18, 59 Fed. Reg. 67,253, 67,254 (Dec. 29, 1994) (withdrawn in 1997, 62 Fed. Reg. 1701 (Jan. 13, 1997)).

36. *See* Burgess J.W. Raby & William L. Raby, *New Incentive for Avoiding SE and FICA Tax*, 81 TAX NOTES 1389, 1390 (Dec. 14, 1998) ("A lobbying barrage indicated that the limited partner exclusion from self-employment tax was getting far more use than anyone seemed to realize.").

37. *See* Temp. Reg. § 1.469–5T(a).

38. *See* Reg. § 1.707–1(c); Rev. Rul. 69–184, 1969–1 C.B. 256 (partner cannot be employee of partnership; partner who performs services classified as independent contractor who is a self-employed individual rather than an employee); *see also* Temp. Reg. § 301.7701–2T (clarifying that a disregarded entity owned by a partnership is not treated as a corporation for purposes of employing a partner of the partnership that owns the disregarded entity; thus, the partner is subject to self-employment taxes); T.D. 9766, 2016–21 I.R.B. 855 (preamble to the temporary regulations).

39. *Example (1)* assumes that none of *A*'s distributive share is attributable to portfolio-type income included under I.R.C. § 1411.

40. *See* I.R.C. § 1411(c)(4); Prop. Reg. § 1.1411–7, 78 Fed. Reg. 72,451, 72,470–74 (Dec. 2, 2013). For SECA purposes, I.R.C. § 1402(a)(3) provides a

A's claimed exemption from all of the 3.8% taxes (except for that SECA tax on any section 707(c) guaranteed payment) reflects the gap between "income and loss" as defined for purposes of the limited partner exception of section 1402(a)(13) and income that is deemed passive under the passive loss rules of section 469. Congress could have eliminated this gap by treating income of a person who claims limited partner status under section 1402(a)(13) as passive for purposes of section 1411, whether or not the material participation test of section 469 is satisfied.[41] *A*'s claimed SECA exemption turns section 1402(a)(13) on its head: rather than protecting the Social Security system, the exception now functions as a "valuable tax preference"[42] for active limited partners to whom the statutory exemption was arguably never intended to apply. Section 1411, which substantially "moots" the original purpose of section 1402(a)(13), lends urgency to closing the employment tax gap.[43]

For purposes of section 1411, investment income is income that falls into one of three categories: (1) gross income from interest, dividends, annuities, royalties, and rent (other than income derived in the ordinary course of a trade or business in which the taxpayer is active) ("Category 1"); (2) other gross income derived from any trade or business in which the taxpayer is passive (or in connection with a Financial Trading Business) ("Category 2"); and (3) net gain (to the extent taken into account in computing taxable income) attributable to disposition

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parallel exemption for disposition gain. *See* N.Y. State Bar Ass'n Tax Section, *Report on the Proposed Regulations under Section 1411* (2013), http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2013/Tax_Section_Report_1284.html [hereinafter NYSBA 2013 Report] (characterizing the exclusion of disposition gain as "more of an inherent feature of the section 1411 statute" that does not depend on classification as a limited partner under I.R.C. § 1402(a)(13)).

41. *See* NYSBA 2013 Report, *supra* note 40, at 51 n.166. Such treatment might be problematic, however, given the explicit statutory reference in I.R.C. § 1411 to the I.R.C. § 469 material participation standard. *See also* T.D. 9644, *supra* note 10, at 703 (preamble notes that interaction between I.R.C. § 1411 and self-employment taxes "is outside the scope of these regulations.").

42. Donald B. Susswein, *Limited Partners and the Self-Employment Tax*, 146 Tax Notes 259 (Jan. 12, 2015).

43. Mayo & Freeland, *supra* note 23, at 428 ("Section 1411 imposes such a tax [on passive income], mooting in substantial part the original purposes of section 1402(a)(13), at least at high incomes.").

of property other than property held in a trade or business (that is not a Financial Trading Business) in which the taxpayer is active ("Category 3").[44] As Table 1 illustrates, *A*'s distributive share and any net gain on disposition (Categories 2 and 3) are exempt from both the SECA and NII taxes if *A* is active:

Table 1

Type of Income	**SECA Excluded**	**NII Excluded**
Interest, dividends, and rent (Category 1)	Yes (§ 1402(a)(1)–(2))	No, unless ordinary course of active trade or business (other than Financial Trading Business) (§ 1411(c)(1)(A)(i), (c)(2))
Other business income (Category 2)	Yes, if state-law limited partner (§ 1402(a)(13)) or S shareholder	Yes, unless passive or Financial Trading Business (§ 1411(c)(1)(A)(ii), (c)(2))
Net disposition gain (Category 3)	Yes (§ 1402(a)(3))	Yes, unless passive or Financial Trading Business (§ 1411(c)(1)(A)(iii), (c)(2))

A remains taxable under section 1411 on portfolio-type income (Category 1). By contrast, if *A* were not active in P's business, *A*'s entire distributive share would be taxed under section 1411 as "other business income" (Category 2) derived from a trade or business in which *A* is not a material participant (within the meaning of section 469). If *A* were passive, gain on sale of *A*'s interest would also be taxed as net disposition gain (Category 3) under section 1411. Thus, section 1411 closes the gap in the SECA-HI tax for high-income earners if *A* is passive but not if *A* is active.[45]

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44. *See* I.R.C. § 1411(c)(1)(A)(i) – (iii), (c)(2). In general, income and gain from a Financial Trading Business cannot avoid I.R.C. § 1411; the intent was to ensure that all income derived from such businesses (including hedge funds) is taxed under I.R.C. § 1411. *See supra* note 10 and text accompanying note 12 (defining a Financial Trading Business).

45. If *A*'s modified adjusted gross income is less than the I.R.C. § 1411 threshold, *A*'s entire distributive share (and net disposition gain) again avoids all employment taxes.

B. Active S Shareholders

Like employees of a C corporation, owner-employees of S corporations are subject to FICA tax on reasonable compensation for services they perform. By contrast, S corporation shareholders are not subject to employment taxes on their distributive share "on the theory that the distributive share represents a return on their capital investment and not compensation for their labor efforts."[46] This rationale, however, is overly broad. Whenever a business combines both labor and capital, the SECA tax base—net business income from a trade or business—inevitably includes a capital-income component.[47] Enacted in 1958, Subchapter S was intended to provide a simple passthrough form while minimizing the distorting effect of taxes on business organizational choice.[48] Although S corporations represent a hybrid of corporate and partnership characteristics, post-1958 statutory amendments have sought to achieve greater parity between tax partnerships and S corporations.[49]

At the inception of Subchapter S, reliance on the reasonable compensation standard applicable to C corporations may have represented a sensible policy choice, given the relatively modest employment tax revenue at stake.[50] Now, the reasonable compensation standard gives

46. George K. Yin & Karen C. Burke, Partnership Taxation 21 (3d ed. 2016).

47. *See* CBO (2012), *supra* note 7, at iv (estimating that 40% of the SECA tax base derives from capital income and the rest from labor income). Furthermore, more than half of the labor income of self-employed individuals is not included in the SECA tax base; when a taxpayer's total net income from all businesses is less than labor income from such businesses, "the excess labor income is excluded from the SECA tax base." *Id.* On balance, the incentives under SECA most likely encourage individuals to choose self-employment. *See id.* at 11. In contrast, nearly all of the labor income of employees (except for employer contributions for health insurance) is subject to FICA taxes. *See id.* at 11–12.

48. *See generally* John K. McNulty & Karen C. Burke, Federal Income Taxation of S Corporations ¶ 1.01 (2d ed. 2015).

49. *See id.* ¶ 10.01.

50. *See* Rev. Rul. 59–221, 1959–1 C.B. 225 (ruling that, because S shareholders do not carry on a trade or business directly, their distributive shares are not included in self-employment income); *see also* Durando v. United States, 70 F.3d 548 (9th Cir. 1995); Ding v. Comm'r, T.C. Memo 1997-435, 1997 WL 588931, *aff'd*, 200 F.3d 587 (9th Cir. 1999). The 1959 ruling predates the

rise to a multi-billion-dollar employment tax loophole that provides S corporations with a substantial advantage over other passthroughs subject to the SECA tax rules.[51] S corporation owner-employees can (and notoriously do) minimize their employment tax liabilities by paying themselves low (or no) salaries, thereby increasing net business income that is passed through unburdened by employment taxes.[52] While the S loophole does not reduce federal income taxes, it dramatically erodes the employment tax base. Section 1411 places even greater pressure on identifying reasonable compensation, since any non-wage income of active S corporation owners avoids the 3.8% NIIT entirely.[53]

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enactment of SECA. *See* Cherie J. Hennig et al., *S Corp Taxation: Level the Playing Field*, 139 Tax Notes 435, 437 (Apr. 22, 2013) (noting that, in 1958, "the maximum Social Security earnings base was $4,200 and the tax rate was 3.38 percent").

51. *See* Treas. Inspector Gen. for Tax Admin., Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations 5 (2005), https://www.finance.senate.gov/imo/media/doc/rgtestrpt052505.pdf (stating that "the S corporation form of ownership has become a multibillion dollar employment tax shelter for single-owner businesses"); *id.* at 13 & 18 (estimating $61 billion tax gap for 2006–2010 attributable to undercompensation of S shareholders and criticizing the "historically inaccurate assumption" of Rev. Rul. 59–221 that most S corporations would have multiple owners); *see also* U.S. Gov't Accountability Office, Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules 25 (2009) [hereinafter GAO, Tax Gap] (estimating that, in 2003 and 2004, S shareholders underreported compensation by roughly $23.6 billion); Smith et al., supra note 13, at 34 (estimating based on the most recent labor data available, that "roughly $116 [billion] of aggregate S-corporation profits are disguised wages.").

52. The tax returns released by former Senator John Edwards and former Speaker of the House Newt Gingrich highlighted the S loophole. *See* Willard B. Taylor, *Payroll Taxes—Why Should We Care? What Should Be Done?*, 137 Tax Notes 983, 988 n.38, 992 n.63 (Nov. 26, 2012) (citing to Gingrich's role in the 1997 moratorium); *see also* Browning & McCormick, *supra* note 15 (estimating that, during the first nine months of 2014, the S loophole may have saved President Trump $1.2 million of tax under I.R.C. § 1411).

53. *See* Office of Tax Analysis, U.S. Treas. Dep't, *Gaps Between the Net Investment Income Tax Base and the Employment Tax Base* 2 (Apr. 14, 2016), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/NIIT-SECA-Coverage.pdf (finding that 60% of active S income escapes both FICA and the NIIT) [hereinafter OTA, *Gaps*].

Beginning in 2013, active S income spiked as high-income taxpayers sought to reclassify as active income (not subject to the NIIT) income previously reported as wages or passive income.[54] In comparison to sole proprietors and general partners subject to SECA, active S corporation owners enjoyed a 3.3 percentage point reduction in their marginal tax rate.[55] The dramatic post-2013 shift into active S income was coupled with a decrease in "other" income (passive income or wages) previously reported by S corporation owners.[56] Thus, high-income S corporation owners responded predictably to the tax incentive to camouflage other types of income as active income outside the NIIT.

> *Example (2)*: Individual *A* is the sole shareholder of an S corporation ("*S*") and works full-time in *S*'s business. In 2017, *A*'s distributive share of *S*'s income is $500,000, and *A* receives a distribution of $50,000, leaving *S* with retained income of $450,000. *A* reports no W-2 income from wages. In a handful of litigated cases, the IRS has successfully recharacterized distributions from S corporations as wages subject to employment tax.[57] Any portion of *A*'s distributive share not recharacterized as wages escapes section 1411, since *A* is active in the business.

Active owner-employees of closely-held C corporations also have an incentive to minimize FICA taxes, but underreporting of

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54. *See* Gerald Auten et al., *Reactions of High-Income Taxpayers to Major Tax Legislation*, 69 Nat'l Tax J. 935, 957–958 (2016).

55. The top marginal Medicare (HI) tax rate on self-employment income (after deduction) is 3.3%—i.e., 2.4% ($2.9\% \times [1-(0.9235 \times 0.5 \times 0.396)]$) plus 0.9% additional Medicare tax. *See id.* at 954.

56. *Id.* at 957 (noting that, in 2011–2014, the increase in active S income accounted for 51% of the total increase in income of the top 0.1%).

57. For a discussion of the case law, see generally Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stan. L. & Pol'y Rev. 127 (2009). For more recent cases, see, e.g., David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010) (using S corporation to avoid SECA tax on distributive share of partnership income; FICA tax limited to reasonable compensation); Fleischer v. Comm'r, T.C. Memo 2016-238, 2016 WL 7479157 (invalid assignment of investment advisory fees to newly-formed S corporation did not avoid SECA tax).

compensation increases taxable corporate income (rather than merely reducing FICA liability) and non-wage distributions potentially face a second level of tax, militating in favor of paying some portion of net business income as deductible wages. No such countervailing influence restrains S corporation owner-employees from underreporting their compensation. Since S corporations are overwhelmingly owned by relatively few shareholders, they have considerable leeway in determining how much to pay their owner-employees.[58] To be sure, responsible advisers would caution taxpayers like *A* to report at least minimal wages (or perhaps wages up to the FICA cap) to reduce the risk of audit.

The tax benefits of operating as an Excluded Business under Subchapter S are certainly not lost on sole proprietors, whose share of net business income has been steadily declining.[59] The tax incentive to incorporate single-owner businesses surely helps to explain why S corporations remain the second most popular business form (outnumbered only by sole proprietorships).[60] Indeed, S corporations have defied predictions that they would be replaced by newer passthrough forms, particularly LLCs, which are taxed under the more flexible partnership rules. Although Subchapter S's defenders praise it as a simple model of

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58. Indeed, "90 percent of S corporations have only one or two shareholders, and 98 percent have 5 or fewer" owners. Susan C. Nelson, *Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980-2013*, at 6 (Office of Tax Analysis, U.S. Treas. Dep't, Working Paper No. 107, 2016), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-107.pdf. Underreporting of income by S shareholders declines as the number of shareholders increases. See CBO (2012), supra note 7, at 13–16; *see also* Nicholas Bull & Paul Burnham, *Taxation of Capital and Labor: The Diverse Landscape by Entity Type*, 61 Nat'l Tax J. 397, 400–01 (2008).

59. Sole proprietorships have been declining. *See* Joseph Rosenberg, *Flow-Through Business Income as a Share of AGI*, 144 Tax Notes 1613 (Sept. 29, 2014).

60. *See* JCX-42-17, supra note 31, at 36 (noting that, in 2014, S corporations represented 12.2% of all business entities). In 2014, there were 3.6 million partnerships and 4.4 million S corporations. *Id.* at 2. Taking into account owner-employee wages, S corporations accounted consistently for a larger share of business income than partnerships during the period 1980–2006; since then partnership income has sometimes exceeded S income. *See* Nelson, *supra* note 58, at 22.

passthrough taxation,[61] critics often point to the employment tax loophole as the dominant reason for the continued existence of Subchapter S.[62]

C. Tiers of Entities

Interposing an S corporation between an individual and a partnership is one of the "workarounds" frequently employed to circumvent the employment tax rules applicable to partnerships.[63] The S corporation eliminates the SECA taint when the partnership distributive share is funneled through the blocker entity. Under a tracing concept, the use of tiered structures could be addressed by treating income that flows from a partnership to an intermediate entity as retaining its self-employment tax character until finally distributed to an individual.[64]

> *Example (3)*: *A* is the sole owner of an S corporation ("*S*") and participates actively in the business of an LLC, which issues an ownership interest to *A*'s S corporation. If *A* (rather than *S*) owned the LLC interest, *A* could not take advantage of the limited partner exception (i.e., an LLC is not a state-law partnership, and *A* is not a state-law limited partner). When *A* receives her distributive share indirectly, as a dividend distribution from *S*, the SECA "taint" is apparently eliminated. Even though the source of *A*'s distribution is *S*'s distributive share of the LLC's income, SECA does not apply to distributions from an S corporation. Alternatively, *S* could employ *A* and lease *A*'s services to the LLC; assuming that *S* is respected as *A*'s

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61. *See, e.g.*, Deborah H. Schenk, *Reforming Entity Taxation: A Role for Subchapter S?*, 146 Tax Notes 1237 (Mar. 9, 2015).

62. *See* Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 Tax Law. 749, 807 (2009) (suggesting that avoiding payroll tax "is a primary, perhaps *the* primary, force behind the use of S corporations"); *id.* at 801 (predicting that resistance to repeal of Subchapter S corporations would fade if the S loophole were closed).

63. *See* Amy S. Elliott, *Self-Employment Tax Exemption Guidance May Be Broad*, 145 Tax Notes 1097 (Dec. 8, 2014).

64. *See* GAO, Tax Gap, *supra* note 51, at 34; NYSBA 2011 Comments, *supra* note 25, at 27–28.

employer and not disregarded as *A*'s alter ego,[65] *A* can take most of her compensation in the form of distributions from *S* (rather than salary); since *A* is active in *S*'s business, *A* avoids all three of the 3.8% taxes.

In *Dagres v. Commissioner*,[66] the taxpayer was a shareholder of an S corporation and an owner of various general partners of venture capital funds. Each general partner received a 20% profits ("carried" interest) and a 2% management fee for its management services. The management fee was paid directly to the affiliated S corporation (which subcontracted to perform the management services), and the taxpayer and other corporate employees actually performed the relevant services. The court held that the general partner was engaged in a trade or business, and imputed that trade or business to the taxpayer. Although *Dagres*'s trade-or-business analysis should not be relevant for purposes of section 1411,[67] the court apparently failed to perceive that the S corporation served to shelter the taxpayer's management fee income from employment tax. Fund managers have historically taken the position that management fee income is SECA-exempt when attributable to an interest in a state-law limited partnership (or S corporation).[68] Because of the exception for active income, such management fees may also be excluded from section 1411.[69]

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65. *See, e.g.*, Roob v. Comm'r, 50 T.C. 891 (1968). Taxpayers often took the position that they were employees of single-member disregarded entities to avoid the rule that partners cannot be employees of a partnership. But as discussed *supra* note 38, temporary regulations have shut down this practice.

66. Dagres v. Comm'r, 136 T.C. 263 (2011).

67. *See* NYSBA 2011 Comments, *supra* note 25, at 36–37 (noting that *Dagres* addresses the "trade or business (if any) of the wrong entity"). The relevant trade or business under I.R.C. § 1411 should be the trade or business of the issuer of the carried interest (not its owner). NYSBA 2011 Comments, *supra* note 25, at 37.

68. Because they are active participants of the investment manager entity through which management services are provided, investment managers typically claim I.R.C. § 1411 does not apply to management fees allocated to them. *See* David S. Miller & Jean Bertrand, *Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers*, 65 Tax Law. 309, 334 (2012).

69. *See infra* notes 131–133 and accompanying text.

III. Post-*Renkemeyer*: Functional Approach

A. LLC Revolution

Although LLCs, LLPs, and LLLPs have radically altered the landscape of passthrough entities since enactment of section 1402(a)(13),[70] the Service has yet to issue definitive guidance concerning application of the employment tax rules to rapidly evolving forms of business organization. LLCs arguably give rise to the most difficult classification issues for employment tax purposes. In a "member-managed" LLC, all of the members may participate in management, like general partners, while in a "manager-managed" LLC, the non-managing members resemble limited partners. LLPs are essentially identical to general partnerships, except that each partner's personal liability is limited under applicable state law. LLPs are popular among professional service partners who seek to insulate themselves from malpractice claims against other partners. Finally, LLLPs are a form of limited partnership with a special liability shield for general partners.[71]

> *Example (4)*[72]: *A*, *B*, and *C* practice in a law firm organized as an LLP under applicable state law. Each partner contributes $10 for a one-third general managing partnership interest ($30 total); the partners, in the aggregate, contribute an additional $970 for equal one-third limited partner interests. Thus, the limited partner interests represent 97% ($970/$1,000) and each one-third general partner interest represents 1% ($10/$1,000) of the economic interests in the partnership. Virtually all of the LLP's income is derived from legal services performed by

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70. Between 1997 and 2004, "the number of limited liability companies increased 263.9 percent" to just under half of all partnerships. Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2004*, SOI Bull., Fall 2006, at 104, 110. In 2014, LLCs represented over two-thirds of all partnerships; before 2002, general partnerships were consistently the most common type of partnership but represented only 15.9% of all partnerships in 2014. Ron DeCarlo & Nina Shumofsky, *Partnership Returns, Tax Year 2014*, SOI Bull., Fall 2016, at 61, 63.

71. LLLP status is most likely to be attractive to existing limited partnerships that wish to provide limited liability for the general partner.

72. Adapted from NYSBA 2011 Comments, supra note 25, at 10 (situation 2).

> *A*, *B*, and *C*, who claim that 97% of such service income is excluded from SECA because it is attributable to their limited partner interests. But for bifurcation of the partnership interests into two classes, each partner's entire distributive share of the LLP's income would be taxed under SECA, since an LLP is not a state-law limited partnership (and *A*, *B*, and *C* actively participate in the LLP's business). For employment-tax purposes, bifurcation potentially allows a partnership interest to be carved into two components: one subject to SECA and one not subject to SECA.[73]

Example (4) closely resembles the fact pattern in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*,[74] a case of first impression. In *Renkemeyer*, the Tax Court held that members of a Kansas limited liability law firm (an LLP) were subject to self-employment tax on their distributive shares.[75] The court indicated:

> "Limited partner" is a technical term which has become obscured over time because of the increasing complexity of partnerships and other flowthrough entities as well as the

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73. See N.Y. State Bar Ass'n Tax Section, *Report on Legislative Proposal Regarding Employment Taxes and Professional Service Businesses* 9 n.13 (2010), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2010/1218_report.html [hereinafter NYSBA 2010 Report] (noting that it is not uncommon for a single economic interest to be subdivided into a small general partner interest and a much larger limited partner interest to minimize SECA taxes).

74. Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C. 137 (2011); *see generally* Sheldon I. Banoff, Renkemeyer *Compounds the Confusion in Characterizing Limited and General Partners—Part 2*, 116 J. TAX'N 300 (2012). The discussion in text ignores the validity of certain special allocations of the LLC's net business income to an S ESOP. *See Renkemeyer*, 136 T.C. at 142–45 (allocations lacked substantial economic effect).

75. The LLP members claimed that their interests resembled limited partner interests because (1) they were designated as "limited partner interests" in the partnership agreement and (2) the members enjoyed limited liability. *Renkemeyer*, 136 T.C. at 147. The partnership agreement provided for two classes of interests: "General Managing Partnership Units" and "Investing Partnership Units." *Id.* at 141.

> history of section 1402(a)(13). We therefore must look to the legislative history for guidance. . . . The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.[76]

According to the court, the purpose of section 1402(a)(13) was "to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage."[77] By contrast, the *Renkemeyer* LLP's income was attributable to legal services, except for a nominal amount of income attributable to invested capital. Thus, the partners' distributive shares "did not arise as a return on the partners' investment and were not 'earnings which are basically of an investment nature.'"[78]

B. Functional Approach

Prior to *Renkemeyer*, case law suggested that limited partner status for purposes of section 1402(a)(13) was determined solely by reference to state law.[79] *Renkemeyer* may signal a shift away from a formalistic

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76. *Id.* at 150. Neither party briefed the relevance of the legislative history of I.R.C. § 1402(a)(13) for purposes of defining a "limited partner." *See* Banoff, *supra* note 74, at 305.

77. *Renkemeyer*, 136 T.C. at 150.

78. *Id.* (quoting H.R. Rep. No. 95-702, *supra* note 22, at 11); *see also* Castigliola v. Comm'r, T.C. Memo 2017-62, 2017 WL 1372505 (member managers of professional limited liability company (PLLC) were not limited partners since they participated in control).

79. *See, e.g.*, Norwood v. Comm'r, T.C. Memo 2000-84, 2000 WL 267779, at *1 (partner's lack of participation in business operations "does not turn his general partnership interest into a limited partner interest"); Johnson v. Comm'r, T.C. Memo 1990-461, 1990 WL 124525 (The I.R.C. § 1402(a)(13) exception did not apply to inactive investor in oil and gas partnership, since "limited partnerships are creatures of agreement cast in the form prescribed by State law" and taxpayer was "bound by the form in which she cast her transaction."); *see also* Methvin v. Comm'r, T.C. Memo 2015-81, 2015 WL 1886217,

approach based strictly on state-law characterization toward one based on the purpose of a particular statutory provision, or a "functional" approach.[80] Nevertheless, the holding in *Renkemeyer* is arguably merely dictum, since the LLP was a state-law general partnership and thus outside section 1402(a)(13) even under the traditional state-law characterization approach.[81] Under this view, the narrow holding of *Renkemeyer* is that state-law labels remain dispositive.[82] It may be hazardous, however, for taxpayers to dismiss *Renkemeyer* so lightly. Given continuing uncertainty following *Renkemeyer*, the Service indicated that taxpayers may continue to rely on the 1997 Proposed Regulations until further guidance is issued.[83]

Renkemeyer invites the Treasury to reexamine the employment tax distinction between limited and general partners but leaves open

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aff'd, 653 F. App'x 616 (10th Cir. 2016) (income from taxpayer's working interest in oil & gas partnership was subject to self-employment income even though taxpayer was passive).

80. Such a functional approach draws support from the 1997 Proposed Regulations, which *Renkemeyer* mentioned only in passing. *Renkemeyer*, 136 T.C. at 148–49.

81. The LLP was formed under Kansas law governing general partnerships; a Kansas partnership that elects LLP status "continues to be the same entity that existed" prior to the election. *Id.* at 148 (citing Kansas law). The court did not address the holding in *Garnett v. Commissioner*, 132 T.C. 368 (2009), that an LLP member is not a limited partner for purposes of I.R.C. § 469. *See also* Newell v. Comm'r, T.C. Memo 2010-23, 2010 WL 538207 (same result for an LLC member); Thompson v. United States, 87 Fed. Cl. 728 (2009) (same), *action on dec.* 2010–14 (Apr. 5, 2010). *Garnett* is clearly inapposite since the I.R.C. § 469 regulations are "neither expressly nor constructively applicable" to I.R.C. § 1402. Banoff, *supra* note 74, at 307; *see also Renkemeyer*, 136 T.C. at 148 (citing *Garnett* only for the proposition that an LLP is a general partnership).

82. *See* Banoff, *supra* note 74, at 314; *id.* at 318 (suggesting that *Renkemeyer* reaches the right result but for the wrong reason). Prior to *Renkemeyer*, many practitioners assumed that bona fide limited partners of law firms organized as state-law limited partnerships were immune from SECA. *See* Elliott, *supra* note 18, at 1244 (quoting Robert R. Keatinge).

83. *See* Elliott, *supra* note 63, at 1098 (quoting Office of Associate Chief Counsel attorney as saying that "[t]he IRS will not challenge an individual that claims to be a limited partner under the proposed regulations as long as the transaction is structured within the four corners of the proposed regulations").

numerous issues. For example, *Renkemeyer* offers no guidance concerning the typical situation in which income is derived from a combination of more than nominal contributed capital and services. The artificial bifurcation of the partners' interests between limited and general partner interests left the court free to adopt an all-or-nothing approach. Rather than carve out an exception for "investment" income, the court treated the partners' entire distributive shares as subject to SECA. *Renkemeyer* addressed only the status of active partners of a state-law general partnership that elected LLP status. The court did not expressly address characterization issues with respect to non-managing members of other entities, such as LLCs and LLPs, whose interests more closely resemble those of limited partners.[84] Read broadly, *Renkemeyer*'s functional approach would potentially treat even active state-law limited partners as subject to SECA, notwithstanding the literal language of section 1402(a)(13).

The Service's post-*Renkemeyer* announcements suggest that it continues to view the 1997 Proposed Regulations as furnishing a safe harbor for employment tax purposes.[85] The 1997 Proposed Regulations set forth a General Rule for establishing limited partner status (whether in a state-law partnership or other entity treated as a partnership for federal tax purposes) and several special rules. Under the General Rule, an individual who is a partner in a partnership will be treated as a limited partner unless the person (1) has personal liability, (2) has apparent authority (under state law) to bind the partnership, or (3) participates in the partnership's trade or business for more than 500 hours per year.[86] Regardless of the three-pronged test and any other exceptions, a service partner in a "service partnership" cannot qualify as a limited partner.[87]

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84. Since *Renkemeyer* apparently gave no weight to limited liability, even an inactive state-law general partner could potentially qualify for the limited partner exception. *See* Banoff, *supra* note 74, at 314.

85. *See* Mayo & Freeland, *supra* note 23, at 408 (noting also that the proposed regulations are not authoritative and are subject to change); Matthew R. Madara, *IRS Considering Guidance on Self-Employment Income Exclusion*, 156 Tax Notes 22 (Jul. 3, 2017).

86. *See* Prop. Reg. § 1.1402(a)–2(h)(2), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).

87. *See* Prop. Reg. § 1.1402(a)–2(h)(5), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). Because of the per se prohibition on service partners, the

Manager members in a manager-managed LLC lack personal liability but have apparent authority under state law. But for the "Multiple-Class-of-Interests" or capital-structure exception, they would automatically be disqualified as limited partners under the General Rule.[88] If a manager member holds a second economic class of membership interest, the capital-structure exception may provide an escape hatch, provided there are non-manager members in the LLC who hold the same economic class of membership interests and meet all of the requirements under the General Rule (including the 500-hour test).[89] For SECA purposes, the managing member's "benchmarked interest" arguably should be treated as equivalent to a non-managing limited partner interest, on the theory that the corresponding distributive share reflects an investment-type return. Under this view, a "dual partner" is presumably adequately compensated for any services through the managing general partner interest. By contrast, no bifurcation is possible in a member-managed LLC because there is no qualifying interest to serve as a benchmark.[90] While the legislative history of section 1402(a)(13) lends support for bifurcation, dual partner status gives rise to potential abuse.[91]

Under the 1997 Proposed Regulations, a non-manager member of a manager-managed LLC may generally qualify as a limited partner if the member participates for less than 500 hours annually in the LLC's business. Some LLC members claim they are sufficiently inactive to qualify as limited partners for SECA purposes but are nevertheless active enough to avoid the NIIT.[92] Such LLC members may fail to satisfy the

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taxpayers in *Renkemeyer* would not have qualified as limited partners under the 1997 Proposed Regulations.

88. *See* Culpepper et al., *supra* note 17, at 216 (referring to "Multiple Class of Interest Exception").

89. The exception applies only if passive investors own a substantial and continuing interest of the same economic class as the benchmarked interest. *See* Prop. Reg. § 1.1402(a)–2(h)(3), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). The bifurcation rule is intended to exclude from SECA tax those portions of a partner's distributive share that are "demonstrably returns on capital invested in the partnership." Preamble, Definition of Limited Partner for Self-Employment Tax Purposes, 62 Fed. Reg. 1702, 1703 (Jan. 13, 1997).

90. *See* NYSBA 2010 Report, *supra* note 73, at 9 n.13.

91. *See* CBO (2012), *supra* note 7, at 5 n.15 (noting that dual partner status "merely provides a more subtle mechanism for manipulating tax liability").

92. *See* OTA, *Gaps*, *supra* note 53, at 4.

500-hour test but nevertheless claim to be material participants under section 469 because they satisfy one of the less stringent tests for non-limited partners. For example, these LLC members may claim that, because the LLC is not formally organized as a state-law limited partnership, they are not limited partners for purposes of section 469. Logically, an LLC member should not be permitted to claim active status under section 469 (thus avoiding section 1411) while simultaneously claiming limited partner status under section 1402(a)(13) (thus avoiding SECA) with respect to the same stream of income.[93] Nevertheless, litigated cases have uniformly held that, for purposes of section 469, LLC members are not limited partners, and the Service has acquiesced on this issue.[94]

In response to the litigated cases, the Service has proposed regulations defining a "limited partner" interest ("LPI") exclusively for purposes of section 469.[95] Like *Renkemeyer*, the proposed regulations under section 469 adopt a functional approach; nevertheless, the purposes of sections 469 and 1411 are not necessarily congruent, inviting taxpayers to exploit statutory gaps. The LPI definition applies to interests in state-law partnerships as well as to interests in other entities (including LLCs) that are treated as partnerships for federal tax purposes. Unlike the 1997 Proposed Regulations, the LPI definition focuses on rights to manage an entity, not on the level of participation.[96] In general, in a member-managed LLC, no member should be treated as holding

93. Some NYSBA members concluded

> [A]n individual should not be able to take the position (i) that he or she is a "limited partner" under section 1402(a)(13) as to a stream of income and (ii) at the same time that the same income is derived from a section 162 trade or business as to which he or she is a material participant (and thus it is not a section 469 passive activity as to the individual).

NYSBA 2013 Report, *supra* note 40, at 58.

94. *See* A.O.D. 2010–14, 2010–14 I.R.B., 2010 WL 2010483.

95. *See* Prop. Reg. § 1.469–5(e), 76 Fed. Reg. 72,875, 72,877–78 (Nov. 28, 2011). Consistent with the functional approach, the proposed I.R.C. § 469 regulations abandon limited liability as a litmus test for limited partner status.

96. *See* Prop. Reg. § 1.469–5(e)(3)(i)(B), 76 Fed. Reg. 72,875, 72,877 (Nov. 28, 2011) (classifying an interest in a tax partnership as an LPI if the holder of the interest lacks ‘‘rights to manage the entity at all times

an LPI interest, since all members have management rights by default. By contrast, non-manager members of manager-managed LLCs lack apparent authority and may thus be caught by the LPI definition. By satisfying one of the more restrictive section 469 tests applicable to limited partners (but flunking the 500-hour test), however, an active LPI holder may still avoid both SECA and the NIIT.[97]

Following *Renkemeyer*, in 2014 the Service issued a Chief Counsel Advisory (the "2014 CCA") addressing the SECA treatment of income earned through an investment management company organized as an LLC.[98] The management company ("Mgt Co LLC"), the successor to an S corporation, was the investment manager for a group of investment partnerships (the "Funds"). Each of the Funds had two general partners, including Mgt Co LLC, which was responsible for managing the investment activities of the Funds.[99] Mgt Co LLC's primary source of income was fees for its management services. Each member of Mgt Co LLC worked full-time for Mgt Co LLC,[100] which treated its members as employees and issued W-2s to them to reflect what Mgt Co LLC claimed was reasonable compensation for their services. For SECA purposes, Mgt Co LLC treated its members as limited partners; the members paid no employment tax on their distributive shares, except for section 707(c) guaranteed payments to cover the cost of health insurance and parking benefits.[101]

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during the entity's taxable year'' under local law and under the partnership agreement).

97. *See* Temp. Reg. § 1.469–5T(a)(1), (a)(5)–(6), (e).

98. *See* C.C.A. 2014-36-049 (Sept. 5, 2014).

99. The other general partner (Profits GP) held a substantial profits interest but did not participate in the investment or trading activities of the Funds; the 2014 CCA did not address the consequences to Profits GP. *Id.*

100. Some members of Mgt Co LLC performed services directly for the Funds (on behalf of Mgt Co LLC) and others performed services for Mgt Co LLC itself. *Id.*

101. Although the cost of health insurance is not deductible from the SECA base, since 2003 self-employed individuals have been able to deduct all of their health insurance premiums for income tax purposes. *See* CBO (2012), *supra* note 7, at 2 n.4. Partners (and S shareholders) generally cannot exclude statutory fringe benefits. I.R.C. § 1372 (treating any "2-percent shareholder" of an S corporation like a partner for purposes of employee fringe benefits); *see also* McNulty & Burke, *supra* note 48, ¶ 3.10.

Relying on *Renkemeyer*, *Riether*,[102] and Revenue Ruling 69-184,[103] the Service determined that the members were not limited partners under section 1402(a)(13) and hence were subject to employment tax on their entire distributive shares.[104] The members' earnings were for services performed and were not a return on capital, even though some members had paid more than a nominal amount for their interests.[105] Since the Mgt Co LLC members were partners (not employees), the reasonable compensation standard was inapplicable. Mgt Co LLC could not change the character of its members' distributive shares by labelling a portion as "wages."[106] Citing *Renkemeyer* and the legislative history of section 1402(a)(13), the 2014 CCA concluded that "Congress did not intend to allow service partners in a service partnership acting in the manner of self-employed persons to avoid paying self-employment tax."[107]

> *Example (5): X* is the majority owner of an LLC, which owns and operates several franchised restaurants. The LLC's remaining interests are owned by *X*'s spouse and by a trust for her benefit. The franchise agreement requires *X* to work full-time in the restaurant business, but neither of the other partners is

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102. Riether v. United States, 919 F. Supp. 2d 1140, 1159 (D.N.M. 2012) (holding that LLC members could not avoid self-employment tax by having the LLC issue them a W-2, since they did not "elect the benefits of corporate-style taxation" under the check-the-box regulations); *see id.* ("The magic words 'unearned income' won't do the trick.").

103. Rev. Rul. 69–184, 1969–1 C.B. 256. *Riether* upheld the Service's position in Rev. Rul. 69–184 that a partner cannot be an employee. *See Riether*, 919 F. Supp. 2d at 1159.

104. For the years at issue, all of Mgt Co LLC's income consisted of fees from the Funds; the investment managers' profit share was paid to Profits GP. C.C.A. 2014-36-049 (Sept. 5, 2014).

105. Some of the partners had been partners since formation of Mgt Co LLC; other partners were formerly non-partner employees who purchased interests in Mgt Co LLC for their net asset value. Since the income was derived from management services, it did not matter that some partners had purchased their interests. *Id.*

106. SECA treatment applied not only to Mgt Co LLC's partners who were investment managers but also to back-office personnel who received a small profits interest. *Id.*

107. *Id.*

> involved in business operations. *X* claims that he reasonably expects a return on his capital investment in excess of compensation for personal services for which he receives section 707(c) guaranteed payments. Accordingly, *X* takes the position that his distributive share of income should be bifurcated for self-employment tax purposes between (1) SECA-exempt income attributable to invested capital (or services of non-owner employees) and (2) compensation for services subject to SECA.

Addressing an identical fact pattern, a 2016 Chief Counsel Advisory (the "2016 CCA") held that the taxpayer's entire distributive share was subject to SECA, notwithstanding the capital-intensive nature of the business and the LLC's numerous non-owner employees, including several executive-level employees.[108] Since the taxpayer actively participated in the LLC's business and performed extensive operational and management services, the 2016 CCA concluded that he was not a limited partner whose distributive share was income of a mere investor.[109] Rejecting the taxpayer's reading of section 1402(a)(13) as excluding "for coverage purposes all earnings which constitute a reasonable return on capital invested in a capital-intensive business," the 2016 CCA noted succinctly that section 1402(a)(13) "provides an exclusion for limited partners, not for a reasonable return on capital."[110] As the 2016 CCA observed, "*Renkemeyer* does not stand for the proposition that a capital-intensive partnership should be treated like a corporation for employment tax purposes."[111] Thus, *Renkemeyer* provided no support for the taxpayer's reasonable compensation argument, which conflated the separate employment tax regimes for partners and corporate shareholder-employees.[112]

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108. *See* C.C.A. 2016-40-014 (Sept. 30, 2016). Although I.R.C. § 1402(a)(13) excludes gain or loss from disposition of property, this exclusion does not apply to a restaurant or retail operation's sales of food or inventory. *See* C.C.A. 2016-40-014 (Sept. 30, 2016).

109. Importantly, the 2016 CCA did not challenge the treatment of the taxpayer's spouse and her trust as limited partners for purposes of I.R.C. § 1402(a)(13), since they performed no services. C.C.A. 2016-40-014 (Sept. 30, 2016).

110. C.C.A. 2016-40-014 (Sept. 30, 2016).

111. *Id.*

112. *Id.*

In Example (5) above, *X* should not be permitted to bifurcate his interest by treating a portion as a limited partner interest, for purposes of section 1402(a)(13), analogous to the interest of a passive investor. If bifurcation is allowed, *X* can assert that, for purposes of section 1411, he is active with respect to his *entire* distributive share (not just the general partner interest) even though any passive investor would be subject to section 1411. Thus, bifurcation potentially allows *X*'s income to escape all three of the 3.8% taxes. In 1997, the drafters of the Proposed Regulations could not have foreseen how the dual partner exception could be used to avoid section 1411. To prevent circumvention of section 1411, the Service should eliminate the dual partner exception.[113] To insulate capital income from SECA, *X* could nevertheless seek to segregate the capital-intensive and service portions of the business in separate entities.[114] While the Service may attempt to aggregate the income of related entities, such a challenge is unlikely to be successful if the parties follow appropriate formalities.[115]

C. Investment and Real Estate Professionals

Renkemeyer and the 2014 CCA call into question common structures traditionally used to shelter investment management fees from employment taxes.[116] Typically, individual investment professionals receive management fees through an investment management entity ("Investment Manager") organized as a state-law limited partnership.[117] The investment professionals hold a limited partner ("LP") interest (directly

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113. *See* NYSBA 2011 Comments, *supra* note 25, at 26.

114. *See* Hardy v. Comm'r, T.C. Memo 2017-16, 2017 WL 168471 (illustrating the common arrangement in which a professional service business is separated into related entities to minimize SECA taxes); *see infra* notes 160–165 and accompanying text.

115. *See* Robucci v. Comm'r, T.C. Memo 2011-19, 2011 WL 240261. Under I.R.C. § 482, the Service could also scrutinize such structures to ensure arm's-length treatment.

116. *See* Amy S. Elliott & Lee A. Sheppard, *Party Ending for Managers' SE, NII Tax Avoidance*, 146 Tax Notes 197 (Jan. 12, 2015).

117. *See* Miller & Bertrand, *supra* note 68, at 385 (describing the typical investment fund structure and noting that "the individual investment professionals will also organize a separate limited liability company or limited partnership to serve as the general partner . . . and hold the carried interest").

or indirectly) in the Investment Manager, as well as a general partner ("GP") interest in an LLC formed to serve as the general partner of the limited partnership. Typically, the GP interests are entitled to 1% and the LP interests to 99% of Investment Manager's profits. The individual investment professionals claim that that they owe self-employment taxes only on a distributive share of income attributable to the 1% GP interest, not the 99% LP interest.[118] The investment professionals also claim that their fee income is exempt from section 1411 because they are active in the investment management business or because their fee income is not "other income" from a trade or business.

Sands v. Commissioner, a recent case docketed in the Tax Court, appears to squarely pose the issue of whether the limited partner exception of section 1402(a)(13) exempts management fees received by individual investment professionals.[119] As the Figure 1[120] depicts, the lowest tier of the *Sands* structure was an operating company, Sands Capital Management LLC ("SCM LLC" or "Opco"). The petitioner, Frank Sands, was one of more than 100 employees of Opco.[121] In turn, Opco was owned 99.32% by Sands Capital Management, LP ("SCM LP") and 0.68% by Sands Family Trust, LLC ("SFT LLC").[122] SFT LLC served as the general partner of SCM LP. Sands owned his limited partner interest in

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118. Relying on I.R.C. § 1402(a)(2)–(3), individual investment professionals also claim that their allocable share of income and gain attributable to a carried interest is exempt from employment taxes. *See* Miller & Bertrand, *supra* note 68, at 386.

119. Petition, Sands v. Comm'r, No. 5650-15 (T.C. Mar. 2, 2015), *reprinted in Individual Challenges Self-Employment Tax Liability in Tax Court*, 2015 Tax Notes Today 95-22 (May 18, 2015) [hereinafter Sands Petition].

120. The chart is reprinted from a Deloitte tax alert. *Internal Revenue Service Acquiesces in Taxpayer Lawsuit Claimant Refund for Self-Employment Taxes Imposed on a Limited Partner*, Deloitte (June 1, 2015), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-sands-vs-comm-alert-060215.pdf.

121. Sands Petition, *supra* note 119, ¶ 6(e). As Chief Investment Officer and Chief Executive Officer of Opco, Sands also received roughly $6.5 million of wages from SCM LLC, presumably subject to FICA. *Id.* ¶ 6(k). He also reported approximately $25,000 of self-employment income on the distributive share which he received as a member of SFT LLC. *Id.* ¶ 6(m).

122. *Id.* ¶ 6(f).

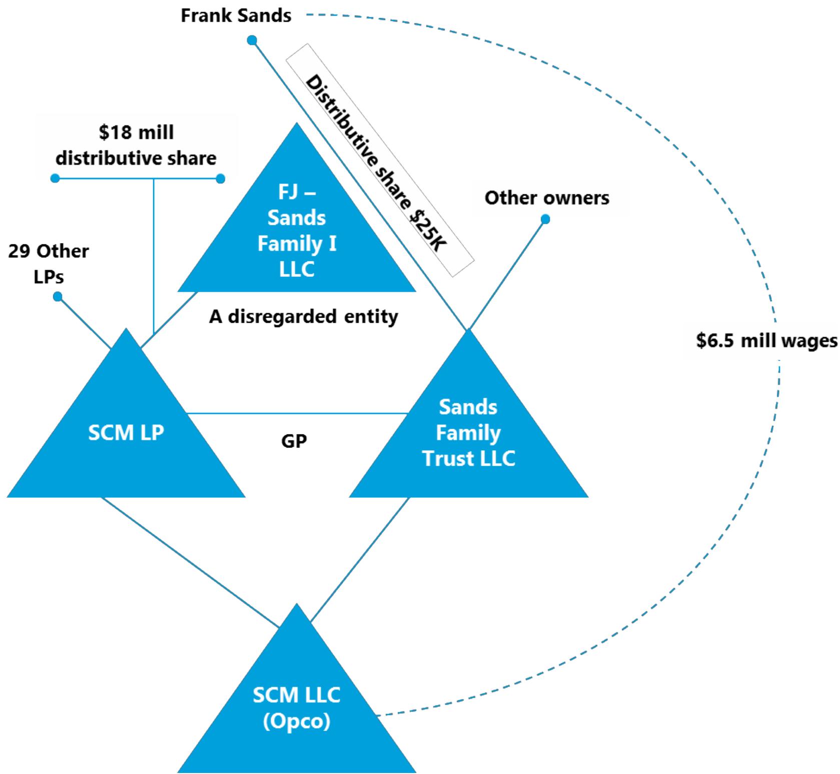

Figure 1

SCM LP through a disregarded entity.[123] On his individual income tax return, Sands reported his distributive share of income (approximately $18 million) from SCM LP but paid no self-employment taxes.[124] Sands claimed that management of SCM LP was vested entirely in its general partner (SFT LLC), and that the limited partners were investors who lacked any management rights and were thus exempt from SECA. Thus, Sands claimed that only the tiny sliver of income, which he received as a member of SFT LLC, the general partner, was subject to SECA.[125]

According to the taxpayer's petition, the government asserted self-employment taxes on Sands's distributive share of income from

123. *Id.* ¶ 6(j).
124. *Id.* ¶ 5(b).
125. *Id.* ¶ 6(m).

SCM LP.[126] In response, the government denied that it had asserted self-employment tax but admitted that it had erred in its determination and requested the Tax Court to grant the taxpayer's requested relief.[127] Although it is "difficult to draw broad conclusions" based on this scant record, *Sands* may suggest that "the Service is either unwilling or believes it does not have the authority to challenge the position that a limited partner who performs services is not subject to SECA."[128] Technically, *Sands* can be distinguished from *Renkemeyer* since an LLP, unlike a state-law limited partnership, has no general partner and no member has unlimited liability.[129] In substance, however, the distributive share received by Sands from SCM LP represented compensation for investment management services, not a return on capital. If Sands had owned an interest in Opco directly (rather than indirectly through SCM LP), his distributive share of Opco's income from management services would clearly have been subject to SECA, since Opco was an LLC.[130]

Although *Sands* preceded the effective date of section 1411, that provision generally does not apply to management fee income. Section 1411 taxes fee income only if it represents "other gross income" derived from a trade or business in which the taxpayer is passive (or is derived from a Financial Trading Business).[131] Investment professionals

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126. According to the taxpayer's petition, "[a]lthough the Commissioner did not identify the specific source of alleged self-employment income [to] which the self-employment tax assessed relates . . . mathematically" the asserted deficiency could only relate to Sands's limited partner interest in SCM LLP. *Id.* ¶ 5(a)–(b).

127. Answer, Sands v. Comm'r, No. 5650-15 (T.C. May 8, 2015), *reprinted in IRS Admits Error in Self-Employment Tax Deficiency Determination*, 2015 Tax Notes Today 95-23 (May 18, 2015). The Tax Court entered a stipulated decision on May 29, 2015, that there was "no deficiency in income tax due from, nor overpayment due to," the taxpayer. Decision, Sands v. Comm'r, No. 5650-15 (T.C. May 29, 2015).

128. Sullivan, *supra* note 12, at 15. Thus, the result might have been different in the 2014 CCA if a state-law limited partnership (rather than an LLC) were employed as the management company in the investment fund structure.

129. *See* Miller & Bertrand, *supra* note 68, at 386 n.361 (noting that "[t]his position is not without risk").

130. *See* C.C.A. 2014-36-049 (Sept. 5, 2014).

131. I.R.C. § 1411(c)(1)(A)(ii) (Category 2). Otherwise, compensation for services is exempt because it does not fall within Category 1 (interest,

take the position that management fee income is not subject to section 1411 because (1) the Investment Manager is not in a business of actively trading securities and (2) the individual investment professionals are active participants (within the meaning of section 469) in the Investment Manager's business of providing management services.[132] In light of Congress's express intent to include in NIIT *all income* from a Financial Trading Business, it may seem anomalous that fee income of hedge-fund managers should escape section 1411. Even if section 1411 were construed to reach fee income from a Financial Trading Business, however, managers of private equity funds might still be able to avoid section 1411 because (1) their fee income is not from managing a Financial Trading Business and (2) they are active in Investment Manager's business.[133]

By contrast, the stream of income attributable to a carried interest in a private-equity or hedge fund will attract section 1411, although the section 162 analysis is different depending on the type of fund. Under the section 1411 regulations, the trade-or-business determination is undertaken at the lowest level at which income arises, i.e., the fund.[134] A typical private-equity fund, which invests in stock of portfolio companies, is engaged in section 212 investment activities, not a section 162 trade or business.[135] Thus, dividends, interest, and capital gain allocable to the carried interest will constitute NII from a non-trade-or-business, and such income will retain its NII character in the hands of the individual investment professionals. By contrast, a hedge fund is likely to satisfy the requirement of an active section 162 trade or business but will be engaged in a Financial Trading Business; income and gain allocable to the carried interest will therefore consist of items subject to the NIIT.

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dividends, and rents) or Category 3 (gains from the disposition of property). I.R.C. § 1411(c)(1)(A)(i), (iii); *see* Peter J. Elias, *Obamacare: A New Tax Incentive for Real Estate Fund Managers?*, 141 Tax Notes 403, 408 (Oct. 28, 2013).

132. *See* NYSBA 2013 Report, *supra* note 40, at 54–55.

133. *See id.* at 58–59; *see also id.* at 59 n.180 (noting that some NYSBA members "have expressed the view that Congress's intent was that all income of individuals be subject to one of these three taxes").

134. *See* Reg. § 1.1411–4(b)(2), (b)(3), Exs. 1–4.

135. *See, e.g.*, Higgins v. Comm'r, 312 U.S. 212 (1941); *cf.* Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987) (focusing on "continuity and regularity").

Congress, however, appears to have created a loophole for active "real estate professionals."[136] Section 1411 specifically excludes rental income derived in the ordinary course of a trade or business, a requirement that is easily satisfied in the case of commercial real estate.[137] In addition to the rental-income exception, active real estate professionals will also be exempt from section 1411 on disposition gain from sale of depreciated real property. Thus, most types of income from real estate funds allocated to a general partner owning a capital or profits interest will fall outside section 1411.[138] Rental income and disposition gain are also exempt from SECA because they are not wages and are specifically excluded.[139] In comparison to other fund managers or passive investors in non–real estate funds, real estate managers thus receive a 3.8% lower rate on most income and gain from real estate funds.[140] In enacting section 1411, however, it is not clear that Congress intended to allow real estate fund managers to escape the 3.8% tax.

In a typical real estate fund organized as a partnership, the carried interest will be held by the general partner ("GP") and a separate

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136. For qualifying real estate professionals, I.R.C. § 469(c)(7) removes the per se passive taint for rental real estate activities, but the taxpayer must nevertheless satisfy the material participation standard. I.R.C. § 469(c)(7)(B); Reg. § 1.469–9(c); Reg. § 1.1411–4(g)(7); *see* Jeffrey D. Eicher & Leo N. Hitt, *Net Investment Income Tax*, TAXES, Sept. 2014, at 23, 30–31 (2014).

137. Under the traditional I.R.C. § 162 analysis for real estate activities, the trade-or-business requirement will generally be met. Eicher & Hitt, *supra* note 136, at 30 (noting that it is "rarely problematic" to meet the trade-or-business requirement in this situation).

138. This assumes that rent is derived in the ordinary course of a real estate trade or business (and gain is from disposition of property held in such trade or business) in which the taxpayer is active. *See* I.R.C. § 1411(c)(1)(A)(i), (iii); *see also* Elias, *supra* note 131, at 405.

139. *See* I.R.C. § 1402(a)(1), (3). Most rental income is received by passive investors and is excluded from the SECA base. *See* CBO (2012), *supra* note 7, at 10 (estimating that only 10% of rental income is subject to SECA).

140. *See* Elias, *supra* note 131, at 404 (noting that, under I.R.C. § 1411, "rental income and gains derived by real estate professionals have been given a unique position" because "[u]nlike most other types of business or investment income, [such] real estate income and gains" will be characterized as "too active" to be subject to I.R.C. § 1411 but "too passive" to be subject to employment taxes). Thus, such real estate income and gains are exempt from all three of the 3.8% taxes.

management entity (affiliated with the GP) will receive fees from services provided to the real estate fund. Real estate professionals who own an interest in the GP or the affiliated management company and perform services for the real estate fund also take the position that section 1411 does not apply to their fee income. But for various workarounds—involving use of limited partnerships, S corporations, and fee waivers—management fees paid to the GP or affiliated management company (and allocable to individual real estate professionals) would normally be subject to SECA.[141] Following enactment of section 1411, real estate professionals have an additional incentive to waive management fees (taxed at ordinary income rates) in exchange for a priority allocation of income and gain (potentially taxed at capital gain rates) from the real estate fund; the priority allocation of income and gain may also escape section 1411 and SECA.[142] As long as the substituted profits interest is sufficiently "risky" to be respected, real estate professionals' *entire* distributive share will therefore constitute income or gain from an Excluded Business.[143]

IV. Closing the Medicare Tax Loophole

Section 1411 imposes a 3.8% tax on unearned income of non-active passthrough owners. Nevertheless, active members of limited partnerships, S corporations, and other tax-transparent limited liability entities claim to be exempt from both employment taxes and section 1411. To eliminate this unwarranted gap in coverage of the Medicare taxes, Congress has two options: (1) repeal section 1402(a)(13) and conform the employment tax treatment of S corporations and partnerships, or (2) expand section 1411 to cover all trade-or-business income of high-income individuals that is not already subject to employment taxes. The latter approach is likely to prove the least disruptive and would remove most of the incentive for high-income passthrough owners to avoid employment taxes.

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141. *See id.* at 409.

142. *See* I.R.C. § 707(a)(2)(A); *see also* Prop. Reg. § 1.707–2, 80 Fed. Reg. 43,652, 43,658–61 (July 23, 2015) (implementing I.R.C. § 707(a)(2)(A)).

143. *See generally* Karen C. Burke, *Taxing Risky and Non-Risky Compensation: Section 707(a)(2)(A)*, J. Tax'n Investments, Summer 2016, at 3.

A. Expanding Section 1411 to Backstop Employment Taxes

The Obama administration's 2017 budget proposal sought to overhaul section 1411 to reduce "unfair and inefficient" distortions based on organizational form and to "improve consistency" in taxing high-income passthrough owners.[144] Under the administration's proposal, the definition of NII would be expanded to include gross income and gain from any trade or business of an individual that is otherwise exempt from self-employment tax.[145] The expanded NIIT base would include gain from sale of property and partnership interests (or S stock), regardless of the level of participation. The proposal would also eliminate the ability of active members of limited partnerships and LLCs to claim exemption from SECA by virtue of section 1402(a)(13).[146] In addition, any non-wage income of high-income S corporation owner-employees would be subject to the NIIT, while any wage income would be subject to SECA (rather than FICA).[147] A special rule would rationalize the treatment of "professional service businesses" by subjecting owners who materially participate in the business to SECA tax on their distributive shares of partnership or S corporation income.[148] Under the expanded definition

144. U.S. Treas. Dep't., General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals 169–70 (2016), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf [hereinafter 2017 General Explanations].

145. *See id.* at 170.

146. The statutory exception under I.R.C. § 1402(a)(13) "would not exclude a limited partner from SECA if the limited partner otherwise materially participated." 2017 General Explanations, *supra* note 144, at 171.

147. 2017 General Explanations, *supra* note 144, at 170. Owner-employees of S corporations could choose between paying FICA taxes on reasonable compensation or SECA taxes on their distributive share (reduced by reasonable compensation). Thus, S shareholders would no longer escape Medicare tax obligations by undercompensating themselves but would have significant flexibility in setting compensation structures. *Compare id.* at 169–71, *with* Hennig et al., *supra* note 50, at 440 (offering similar proposal under which "shifting wage income to investment income would not change the total tax result" for owner-employees of S corporations); *see id.* at 440–41 (describing the interaction between FICA deduction for wages and SECA tax on remaining distributive share).

148. *See* 2017 General Explanations, *supra* note 144, at 171. Professional service businesses would be defined broadly to include partnerships,

of professional service businesses, investment and real estate management fees would generally be subject to SECA, while real estate professionals could no longer exclude disposition gains from the NIIT.

The NIIT "reflects an intention to impose the 3.8 percent tax on both earned and unearned income of high income individuals."[149] It falls short of this goal, however, by defining NII affirmatively rather than as the residual category of trade-or-business income that escapes both FICA and SECA taxes.[150] While Congress may have assumed that active income of partners (including LLC members) would be subject to SECA, the section 1411 exception for active S corporation shareholders is inexplicable as a policy matter. Broadening the scope of section 1411 to pick up all income not otherwise subject to employment taxes would greatly reduce tax-motivated distortions in the choice of organizational form. Subjecting investment and real estate management fees to SECA, while eliminating the unique Medicare tax loophole for real estate professionals, would improve horizontal equity.

An expanded NIIT would help to close the Medicare financing gap.[151] The additional revenue would flow into the Medicare Hospital Insurance Trust Fund, eliminating a disparity between the NIIT and the FICA-HI and SECA-HI taxes.[152] Historically the Medicare portion of Social Security has been funded primarily through payroll taxes. Nevertheless, "there was no inevitable reason for that connection," since payroll contributions do not provide any additional Medicare benefits once basic coverage is established.[153] In the long run, sensible reform

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S corporations, or other entities taxed as partnerships "substantially all the activities of which involve the performance of services" in the traditional fields of health, law, and accounting, as well as certain other fields such as investment advice or management. *Id.*

149. *Id.* at 169–70.

150. *See* Lee A. Sheppard, *Can Fund Managers Escape Self-Employment Taxes?*, 145 Tax Notes 351, 354 (Oct. 27, 2014) (noting that "[t]he legislative mistake in section 1411 was in defining the key concept of net investment income affirmatively").

151. In 2017, the administration's proposal would have raised additional revenue of about $16.7 billion. 2017 General Explanations, *supra* note 144, at 269 (projecting additional revenue of around $272 billion over a ten-year period from 2016 to 2025).

152. *See id.* at 170.

153. Richard L. Kaplan, *Rethinking Medicare's Payroll Tax After Health Care Reform*, Taxes, Aug. 2011, at 43, 46; *see also* Dilley, *supra* note 27,

might include restructuring section 1411 as a dedicated surcharge to the individual income tax for earners above the $250,000 threshold, with appropriate credits for any FICA or SECA taxes on wages and self-employment income.[154] Since a larger share of the income of lower-income taxpayers is, on average, subject to the Medicare tax, expanding section 1411 would be more progressive than an across-the-board increase in the hospital insurance tax. Self-help measures by high-income passthrough owners to avoid all three of the 3.8% taxes merely exacerbate the problem of placing Medicare financing on a sustainable path.[155]

B. Material Participation Standard to Achieve Passthrough Parity

An alternative approach would be to rationalize the employment tax treatment of passthroughs to achieve greater parity among different organizational forms. In 2005, the Staff of the Joint Committee on Taxation ("JCT") proposed to treat partners and shareholders of S corporations as subject to SECA in the same manner as general partners and sole proprietors under current law.[156] Treating S corporations as subject

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at 70. Indeed, in 1993 Congress foresaw that it might be desirable to "revisit the issue [of uncapped Medicare taxes on high earners] in the context of health care reform or Medicare financing improvements." H.R. Rep. No. 103-213, at 580 (1993) (Conf. Rep.).

154. *See* Dilley, *supra* note 27, at 94–95 (arguing for an income tax surcharge as part of an approach that would separate "the benefit accrual functions of the SECA tax from its revenue collection functions"); Dilley, *supra* note 34, at 426–27. *See generally* Willard B. Taylor, *Should Payroll Taxes Be Repealed?*, 148 Tax Notes 213 (July 13, 2015); Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 Va. Tax Rev. 1 (2002).

155. Indeed, elimination of the additional 0.9% tax on high earners would accelerate the projected insolvency of the Medicare hospital insurance trust fund by three years, from 2028 to 2025. *See* Chye-Ching Huang et al., *House GOP Health Plan Eliminates Two Medicare Taxes, Giving Very Large Tax Cuts to the Wealthy*, Ctr. on Budget & Pol'y Priorities 3, https://www.cbpp.org/sites/default/files/atoms/files/1-6-17tax.pdf (last updated Mar. 20, 2017).

156. Joint Comm. on Tax'n, 109th Cong., JCS-02-05, Options to Improve Tax Compliance and Reform Tax Expenditures 96–99 (2005) [hereinafter 2005 JCT Proposal]. The JCT staff recommended eliminating FICA withholding on owner-employee wages and instead applying SECA to both wages and distributive shares of S corporation shareholders. *See id.* at 103–04

to SECA (not FICA) would be consistent with the modern approach to taxing S corporations like partnerships. Under the 2005 JCT proposal, the reasonable compensation standard would be relevant only in the case of a partner (or S shareholder) who did not materially participate. Except in the case of service partnerships, the 2005 JCT proposal would generally have retained the current SECA exclusion for specific, readily identifiable types of capital income ("Excluded Income"), such as rents, dividends, interest, and capital gains. In the case of a "service partnership," however, SECA would apply to all income of an active partner (or S shareholder), including otherwise Excluded Income.[157] The 2005 JCT proposal comes closest to putting passthrough owners and sole proprietors on an equal footing, while minimizing situations in which determination of reasonable compensation would be necessary.[158]

Since the 2005 JCT proposal would subject only active participants to self-employment taxes, it would still be necessary to determine whether owner-employees satisfy the material participation standard. A material participation standard would likely require aggregation of trades or businesses under common control. Otherwise, passthrough owner-employees would have an incentive to avoid status as a material participant by forming "series" entities with overlapping ownership.[159] In the section 469 context, partners with net losses have an incentive to satisfy the material participation standard, so that active losses can be used to shelter income from other sources. By contrast, partners with

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(noting that preserving FICA on wages would require a mechanism to prevent double counting).

157. *Id.* at 99–104. The JCT's 2008 proposal was essentially identical except that the Excluded Income exception was retained for service partnerships, subject to anti-abuse rules. Joint Comm. on Tax'n, 110th Cong., JCX-48-08, Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity 69–71 (2008) [hereinafter 2008 JCT Proposal].

158. *See* Richard Winchester, *Carried Interest for the Common Man*, 142 Tax Notes 1250, 1256 (Mar. 17, 2014) (noting that the 2005 JCT Proposal, *supra* note 156, "virtually eliminates the disparities between the taxation of sole proprietors" and owners of passthrough entities but recommending that the proposal be extended to self-employed individuals owning closely-held C corporations).

159. *See* NYSBA 2011 Comments, *supra* note 25, at 19 (noting that passthrough owners should not be able to avoid a material participation standard "simply by forming a series of related entities and dividing their services among them").

positive net income have an incentive to fail the material participation standard in order to use passive losses from other sources to offset such income. In the SECA context, however, failing the material participation standard would nearly always be beneficial to avoid triggering employment tax liability.

Under section 469, recharacterization rules are intended to prevent taxpayers from generating passive income to offset passive suspended losses. In general, section 469 treats as nonpassive income (but not loss) from a "significant participation passive activity"—a trade or business in which an individual significantly participates (for more than 100 hours) but does not materially participate.[160] While generally disadvantageous for purposes of section 469, this treatment will often be advantageous for purposes of section 1411, since the taxpayer can claim active status by participating for only 101 hours in an activity.[161] The section 469 rules also offer considerable flexibility in grouping activities.[162]

> *Example (6)*: *X*, a surgeon, together with several colleagues, forms an LLC to own and operate a surgery center. The LLC enters into an arrangement whereby each surgeon receives a distributive share of the center's net earnings from facility fees charged to patients. The LLC does not pay the surgeons separately, and each surgeon bills patients independently for services rendered. *X* claims that his share of income from the LLC is passive under section 469 for purposes of offsetting passive losses from other sources. *X* also claims that section 1402(a)(13) applies because he is a mere investor. In a reversal of the parties' normal litigating postures, the Service challenges *X*'s treatment of the LLC income as passive on the ground that *X*'s practice should properly be grouped with the LLC's surgery center.

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160. Temp. Reg. § 1.469–2T(f)(2)(ii).

161. *See* Mark Berkowitz & Jessica Duran, *100 Is the New 500—Planning for the NII Tax*, 146 Tax Notes 1625, 1631 (Mar. 30, 2015). Net losses nevertheless remain nonpassive for purposes of determining the taxpayer's NIIT (and may be used to shelter disposition gain from the 3.8% tax). *See id.*

162. Reg. § 1.469–4.

In *Hardy v. Commissioner*[163] involving similar facts, the Tax Court rejected the government's argument, holding that the taxpayer did not have a principal purpose of circumventing section 469 by splitting up the two businesses.[164] It also held that the taxpayer's distributive share of the LLC's income was not subject to SECA because "he received the income in his capacity as an investor."[165] Thus, the Tax Court seems to have created a novel SECA exemption for passive investors in LLCs. In discussing section 469, the Tax Court also failed to consider whether the taxpayer's income might be recharacterized as nonpassive under the significant participation passive activity rules. *Hardy* illustrates the dilemma of implementing a material participation standard when the taxpayer has an incentive to avoid active status to minimize SECA taxes, while remaining sufficiently active to avoid section 1411.

A material participation standard modeled on the 2005 JCT proposal would raise substantial revenue but would also likely increase the overall percentage of capital income included in the SECA base.[166] Passthrough owners would have an increased incentive to separate capital-intensive facets from labor-intensive facets of businesses and to recharacterize income as SECA-exempt forms of income, such as rent and interest. Subjecting an S corporation shareholder's distributive share to SECA would provide an incentive to switch from S to C status; active participants might find it attractive to pay corporate tax in order to avoid a 15.3% SECA tax on top of their individual income tax. A lower

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163. Hardy v. Comm'r, T.C. Memo 2017-16, 2017 WL 168471.

164. In *Hardy*, the government also argued that the taxpayer was bound by his reporting of income from the LLC as nonpassive in prior years. *Id.* at *26. For an example of an abusive grouping involving medical services, see Reg. § 1.469–4(f)(2), Ex.

165. *Hardy*, 2017 WL 168471, at *32.

166. The Congressional Budget Office estimated that a material participation standard would raise $129 billion of additional revenue over the period 2014 to 2023. *See* Cong. Budget Office, Options for Reducing the Deficit: 2014 to 2023, at 147 (2013); *cf.* ABA Tax Section, *Comments on Additional Options to Improve Tax Compliance Prepared by the Staff of the Joint Committee on Taxation* 7 (Mar. 15, 2007), https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/2007/070315jctreport.authcheckdam.pdf [hereinafter 2007 ABA Proposal] (characterizing the 2005 JCT Proposal as "a wholesale expansion" of the employment-tax base that "would not simply close the 'tax gap' [but] would represent a significant change in law").

corporate tax rate exacerbates the problem, even if distributed C profits remain potentially subject to a second level of tax.[167] On balance, expanding section 1411 might prove less disruptive: disparities in organizational form would no longer prove so susceptible to manipulation by active high-income passthrough owners intent on escaping their Medicare taxes.

C. Return-on-Capital Exclusion

Rather than rely on a material participation standard to distinguish "active" owner-employees from passive investors, it would be possible to allow a reasonable return on invested capital to be excluded from the SECA base, while treating residual amounts in excess of a reasonable return to capital as labor income.[168] The 2005 JCT proposal rejected an imputed return on capital as excessively complex and unnecessary.[169] Nevertheless, the return-on-capital approach continues to be touted by the organized bar and professional accountants, as exemplified by the recommendations of the ABA Section of Taxation and the American Institute of Certified Public Accountants ("AICPA").[170] Under the

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167. The TCJA reduces the maximum corporate tax rate from 35% to 21%, applicable for taxable years beginning after December 31, 2017. I.R.C. § 11(b); TCJA, *supra* note 3, § 13001(a), (c).

168. *See* 2005 JCT Proposal, *supra* note 156, at 101.

169. The JCT staff concluded that a return-on-capital approach "may not represent the simplest and most direct approach, nor would it be accurate in most cases." *Id.* at 101 n.227. The 2005 JCT proposal instead opted for the simpler approach of exempting certain classes of income, such as dividends and interest. *Id.* at 101–02.

170. *See* ABA Tax Section, *Tax Rules Governing Self-Employment Income of Limited Liability Companies and Partnerships* (2002), https://www.americanbar.org/content/dam/aba/administrative/taxation/migrated/pubpolicy/2002/020529c.authcheckdam.pdf; Am. Inst. of Certified Pub. Accountants, *Legislative Proposal Regarding Tax on Self-Employment Income Under Section 1402 of the Internal Revenue Code of 1986*, *reprinted in AICPA Forwards Legislative Proposal on Self-Employment Taxes*, 98 Tax Notes Today 39-34 (Feb. 19, 1998); *see also* 2007 ABA Proposal, *supra* note 166. In 2011, the ABA Tax Section proposed to amend I.R.C. § 1402(a)(13) to "focus on whether income is attributable to services provided or capital contributed to a partnership . . . and to provide that income that is attributable to capital is not subject to SECA." ABA Tax Section, *Options for Tax Reform in the Partnership Tax Provisions of*

ABA/AICPA recommendations, partners could exclude an amount of trade-or-business income from the SECA base equal to the lesser of (1) their net income in excess of reasonable compensation or (2) a safe-harbor return on invested capital. Substantively, sole proprietors would also be eligible to claim a SECA exemption for an amount of reasonable compensation (or a safe harbor return). Since the "vast majority" of owner-employees would likely opt for a reasonable compensation standard,[171] the ABA/AICPA recommendations would implicitly extend the current unsatisfactory S corporation model to partners and sole proprietors.[172]

In structuring the employment tax rules, two broad conceptual approaches are possible: an inclusionary approach and an exclusionary approach.[173] The current SECA rules generally reflect an inclusionary approach, i.e., all net earnings from self-employment income are subject to the SECA tax, except for clearly identified categories of capital income (Excluded Income). Under an inclusionary approach, the

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the Internal Revenue Code 7 (2011), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/120211comments-1.authcheckdam.pdf.

171. CBO (2012), *supra* note 7, at 34; *see* Schwidetzky, *supra* note 62, at 793 ("Of course, what the AICPA is likely trying to do is limit partners' NESE as much as practicable."). In 2007, the ABA Tax Section recommended creating a "presumption amount" of reasonable compensation for active pass-through owners equal to the annual OASDI base. 2007 ABA Proposal, *supra* note 166, at 9–10; *cf.* Schwidetzky, *supra* note 62, at 796 ("[I]t is a safe bet that the vast majority of partners [would] limit their compensation to be the presumption amount, and large amounts of what should be compensation income [would] escape Social Security and Medicare taxes.").

172. Based on an aggressive reading of the dual partner exception, one commentator recently characterized the "basic approach" of the 1997 Proposed Regulations as exempting "a reasonable, arm's-length return on [a] partner's capital investment." Donald B. Susswein, Letter to the Editor, *Making the Case for the Passthrough Tax Rate Drop*, 155 Tax Notes 1191, 1191 (May 22, 2017); *cf.* Schwidetzky, *supra* note 62, at 792 ("The difficulty with the [1997] Proposed Regulations is that they do not tackle the income-from-capital versus income-from-services issue head-on.").

173. *See* Dilley, *supra* note 27, at 68, 97–99. While the difference between the inclusionary and exclusionary approaches may appear to be "simply one of threshold presumptions, the substantive and procedural differences are significant and raise different problems." *Id.* at 68; *see also id.* at 98 (noting that one major difference concerns the "degree of administrative resources" needed to properly police the SECA rules under either assumption).

anachronistic limited partner exception under section 1402(a)(13) should be eliminated, since it no longer serves reliably to identify passive income.[174] By contrast, an exclusionary approach would treat net earnings of an individual from a trade or business as exempt from SECA tax, except to the extent that such earnings were clearly derived from performance of personal services.[175] The ABA/AICPA recommendations—despite their seemingly inclusionary nature—actually exemplify an exclusionary approach. They would impose an excessive administrative burden on the Service to detect and challenge taxpayer attempts to blur the distinction between capital and labor income.

While the conceptual base of the SECA tax is often stated to be labor income, SECA has always been an odd choice for measuring wage-like income of self-employed individuals.[176] The argument that SECA "overtaxes" capital income ignores the difficulty of distinguishing between labor income and capital income when owner-employees contribute both capital and services.[177] Ironically, a well-designed capital income allowance would likely have relatively little effect on the overall percentage of capital income included in the current SECA base.[178] To avoid duplication, an imputed return should not be allowed for

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174. *See* Mayo & Freeland, *supra* note 23, at 428 ("Thus, section 1402(a)(13) has become a gap in the coverage of hospital insurance taxes generally.").

175. For an example of an exclusionary approach, see Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?*, 17 Va. Tax Rev. 811, 861 (1998) (proposing "a rebuttable presumption in favor of investor status" for all passthrough owners, unless the material participation standard were satisfied).

176. *See* 2005 JCT Proposal, *supra* note 156, at 101; *cf.* Dilley *supra* note 27, at 67 (noting that "the SECA tax is not really a wage tax at all, but rather is a kind of income tax, on that part of the self-employed person's income that looks most like wages").

177. In reality, the "current payroll tax simply ignores [the] problem [of separating capital and labor] and thus taxes some of the capital income of [closely-held] businesses." Jane G. Gravelle, The Economic Effects of Taxing Capital Income 49 (1994); *see id.* ("While wage taxation may appear to be quite straightforward, it is extremely difficult—indeed, probably impossible—to separate capital income from labor income for closely held businesses where the owner may supply both capital and labor services.").

178. *See* CBO (2012), *supra* note 7, at 24 (concluding that "the safe-harbor exclusion would have had [only] small effects" for limited partners

financial assets that currently generate Excluded Income, such as interest, dividends, and other capital income.[179] For sole proprietors, it would also be necessary to exclude cash (and similar items) that could otherwise be mischaracterized as business assets. Indeed, most sole proprietors would find the detailed record-keeping needed to segregate personal and business assets impractical for purposes of computing a safe-harbor return on capital. Since sole proprietors have personal liability for obligations and activities of the business, disentangling mixed personal and business assets is challenging both practically and conceptually.[180] Sole proprietors would have the same incentive to understate their compensation (thus overstating a return to capital) as S shareholders under current law.

There are strong arguments for limiting any safe-harbor return on capital to the adjusted tax basis (rather than value) of assets and excluding intangibles.[181] When assets are appreciated, using tax basis would reduce valuation disputes and offset the advantage of tax deferral.[182] Although appreciated intangibles represent a significant component of value for many service businesses, appreciation in such assets often masks a return to labor. Thus, including intangibles in the capital base would raise difficult issues concerning self-generated goodwill or

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and LLC members); *id.* (noting small percentage decrease in overall share of capital income included in SECA and SECA-HI bases).

179. *See id.* at 23.

180. *See* Claire Crawford & Judith Freedman, *Small Business Taxation*, *in* Dimensions of Tax Design: The Mirrlees Review 1028, 1041 (Inst. for Fiscal Studies ed., 2010) (noting that these concerns are "not merely a practical detail"). Allowing sole proprietors to exclude reasonable compensation would substantially erode the SECA base.

181. Given the generous rules for expensing new investments, many small businesses would often have only a negligible tax basis for purposes of imputing a return on capital. By comparison, the TCJA, *supra* note 3, § 11011, allows taxpayers to use the original cost of depreciable property, i.e., the *unadjusted* tax basis of such property, to determine the deduction for qualifying business income. I.R.C. § 199A(b)(2)(B)(ii) (codification of TCJA provision).

182. *See* Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 Tax Notes 641, 652 (Feb. 1, 2010) (excluding appreciation from a return-on-capital allowance "merely reduces the advantage of tax deferral").

"enterprise value."[183] Imputing a return based on value (rather than tax basis) would require an elaborate capital-account system and tracking of built-in gain (or loss) in contributed or revalued property. As the carried-interest controversy demonstrates, determining a reasonable return on "invested capital" would be inordinately complex.[184] Under current law, S corporations are spared the intricacies of section 704(c) adjustments and mandatory basis adjustments under sections 734(b) and 743(b). Importing these concepts into Subchapter S would represent a dubious contribution to tax simplification.

As a trade-off for repealing the section 1402(a)(13) exception and subjecting S corporation shareholders to SECA, the 2014 Camp proposals offered a new deduction for a portion of an individual's SECA income derived from a partnership or S corporation.[185] The deduction would generally be capped at 30% of net earnings (adjusted for wages reported) but would be 100% in the case of individuals who did not materially participate.[186] Although the Camp proposals gained no traction,[187] a similar percentage deduction for capital income was touted as a means of providing relief for passthrough businesses to

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183. *See, e.g.*, Karen C. Burke, *Comments on "Taxation of Intellectual Capital:" Better Than Consumption-Tax Treatment?*, 66 Fla. L. Rev. F. 47, 50–51 (2015). It would also require introducing some form of I.R.C. § 751(b) to S corporations to preserve ordinary income tax on the compensation-flavored component of appreciated intangibles.

184. *See* 2008 JCT Proposal, *supra* note 157, at 60 n.123.

185. Joint Comm. on Tax'n, 113th Cong., JCX-12-14, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title I—Tax Reform for Individuals 82–85 (2014).

186. The exclusion level was apparently chosen because it approximates the portion of gross domestic product that is attributable to capital. *See id.* at 83; *see also* CBO (2012), *supra* note 7, at 16 n.34 ("Many studies have assumed that 65 percent of proprietors' income comes from labor.").

187. The Camp proposals were roundly criticized by the S lobby as threatening the S employment tax loophole. *See, e.g.*, Willard Taylor, *Does One Size Fit All? Should There Be a Single Set of Federal Income Tax Rules for S Corporations and Partnerships?*, 8 Entrepreneurial Bus. L.J. 327, 336–41 (2013); Karen C. Burke, *Unified Passthrough Reform Misses the Mark*, 146 Tax Notes 1371, 1374 (Mar. 16, 2015).

compensate for a reduction in the corporate tax rate.[188] Indeed, the original House version of the 2017 tax reform resembled the Camp proposals. In the case of active passthrough owners, 70% of qualified business income ("QBI") was presumptively treated as labor income (taxed at ordinary income rates); the remaining 30% was attributed to capital and taxed at a preferential rate of 25%.[189] In the case of passive passthrough owners, the preferential rate applied to 100% of QBI.[190] Although the House bill initially proposed to eliminate the SECA exception for limited partners (and impose SECA tax on 70% of active S earnings), repeal of section 1402(a)(13) was quickly abandoned and never resurfaced.[191]

As finally enacted, the 2017 legislation provides an unwarranted maximum deduction of 20% for QBI (whether passive or active) in the non-corporate sector.[192] For higher-income taxpayers, the maximum deduction is further limited to 50% of W-2 wages paid to both owner- and non-owner employees.[193] Under an alternative capital-based limit, a

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188. *See* Lily Batchelder, *Trump's Giant Tax Loophole*, N.Y. Times (May 30, 2017), https://www.nytimes.com/2017/05/30/opinion/trump-tax-plan-pass-through-business.html; Jeffrey Rohaly et al., *Options to Reduce the Taxation of Pass-Through Income*, Tax Pol'y Ctr. 3 (May 15, 2017), http://www.taxpolicycenter.org/sites/default/files/publication/141541/options-to-reduce-the-taxation-of-pass-through-income.pdf.

189. *See* Joint Comm. on Tax'n, 115th Cong., JCX-50-17, Description of H.R. 1, The "Tax Cuts and Jobs Act," 17–18 (2017) [hereinafter JCX-50-17]. The 30/70 split resulted in a blended tax rate of 35.22%, i.e., (25%×30%) + (75%×39.6%). A higher capital percentage could be claimed based on the adjusted tax basis of assets used in the qualified trade or business. *See id.* at 20–21.

190. *See id.* The House approach created a perverse incentive to classify business income as passive (rather than active) to gain access to the preferential rate. *See* Samuel C. Thompson Jr., *Taxing Trump and Curry Under the Republican Plan*, 157 Tax Notes 1149 (Nov. 20, 2017).

191. *See* JCX-50-17, *supra* note 189, at 22.

192. *See* I.R.C. § 199A(b)(2), (c)(1).

193. *See* I.R.C. § 199A(b)(2)(B). The W-2 limit does not apply if a single taxpayer's total taxable income for 2018 is less than $157,500 ($315,000 for a married couple); the phase-in range for the W-2 limitation in 2018 is $157,000–$207,500 (single) and $315,000–$415,000 (married). *See* I.R.C. § 199A(b)(3), (e)(2). Qualified dividends from REITs and income and gain from publicly-traded partnerships automatically qualify for the preferential rate. *See* I.R.C. § 199A(b)(1)(B).

capital-intensive business (such as a real estate business) with tangible depreciable property can obtain the maximum deduction even if it has no employees and such property is nearly fully depreciated.[194] Except in the case of certain specified service businesses such as investment management, the deduction is available even to most service businesses.[195] When the maximum deduction is allowed, QBI is taxed at only 29.6% (80%×37%), 7.4 percentage points lower than the maximum individual rate of 37%. The total gap is now 11.2 percentage points between the preferential passthrough rate (29.6%) and the top rate at which labor income is taxed (37% plus 3.8%).

The 2017 tax reform leaves intact planning to avoid employment taxes and the NIIT, while dramatically lowering the income tax rate on business income. It introduces new disparities in choice of business entity and taxes different categories of income differently, depending on whether such income is earned by a passthrough owner (or sole proprietor or independent contractor) or by a salaried employee. The existing incentives are magnified for active S corporation owner-employees to pay themselves minimal salaries (just enough to maximize the wage-based deduction), thereby avoiding SECA taxes while leaving more business income to be taxed at the 29.6% rate.[196] Active partners and sole proprietors may fare even better because, unlike their S counterparts,

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194. *See* I.R.C. § 199A(b)(2)(B)(ii), (b)(6). For example, assume that a taxpayer has $1 million of QBI, no employees, and owns depreciated real property with an original cost basis of $8 million and an adjusted basis of near zero. Under the alternative limit, the taxpayer is nevertheless entitled to the maximum 20% deduction ($200,000) equal to 2.5% of the unadjusted basis of the depreciable property (2.5% of $8 million and an adjusted basis of near zero equals $200,000). *See* Patricia Cohen & Jesse Drucker, *Tax Plan Crowns a Big Winner: Trump's Industry*, N.Y. Times (Dec. 5, 2017), https://www.nytimes.com/2017/12/05/business/economy/tax-bill-real-estate.html.

195. *See* I.R.C. § 199A(d)(1)–(2). Even in the case of specified service businesses, the deduction is disallowed only for higher-income taxpayers. *See* I.R.C. § 199A(d)(3).

196. *See* I.R.C. § 199A(c)(4) (providing that QBI is reduced by reasonable compensation and certain payment under I.R.C. § 707(a), (c)). For example, the maximum 20% deduction can be obtained if an S corporation pays its owner wages equal to 28.57% of QBI before wages. Thus, if pre-wage business income is $100 and wages are $28.57, S corporation income after wages is $71.43 and the 20% deduction is $14.29 (20%×$71.43), i.e., half the wage amount.

they are unconstrained by any requirement to pay reasonable compensation for the value of services performed.[197] Investment managers may find it advantageous to reclassify themselves as employees in order to pass along the benefit of the preferential rate to passive fund investors employing them.[198]

V. Conclusion

Although lowering the passthrough rate was ostensibly necessary to preserve "competitiveness" between passthrough and corporate businesses, the former could have obtained access to the lower corporate tax rate simply by electing to be taxed as corporations.[199] The 2017 legislation provides a massive tax cut to wealthy business owners and exacerbates growing inequality in the taxation of labor and capital income.[200] Earlier proposals to promote uniformity in employment taxation have encountered entrenched and vociferous opposition from the passthrough sector.[201] This Article suggests that expanding section 1411 offers a more promising path—one that would directly target high-income

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197. *See* Michael L. Schler, *Reflections on the Pending Tax Cuts and Jobs Act*, 157 Tax Notes 1731, 1738 (Dec. 18, 2017).

198. Even though investment managers would pay employment taxes, the tax benefit to investors from the enhanced § 199A deduction would likely outweigh the additional tax cost.

199. For an alternative approach for passthroughs, see Daniel Halperin, *Corporate Rate Reduction and Fairness to Passthrough Entities*, 147 Tax Notes 1299 (June 15, 2015).

200. *See* Cooper et al., *supra* note 13, at 94 ("Overall, 69% of passthrough income earned by individuals accrues to the top 1%."); *id.* at 96 (noting that "pass-through business income accrues much more disproportionately to high-earners than C-corporate income"); Sheppard, *supra* note 150, at 356 ("More broadly, the various employment tax loopholes show tax discrimination against salaried employees of regular business corporations and in favor of employees of passthrough entities receiving equity compensation."); *see also* Smith et al., *supra* note 13, at 6 (noting that the ability of S corporation owners to disguise labor income as S income, thereby avoiding employment taxes, undermines overall progressivity and "creates horizontal inequities between top earners").

201. *See* Dilley, *supra* note 27, at 92 (noting that the "principal objective [of reform proposals] is uniformity of taxation of members of different types of pass-through entities"); Taylor, *supra* note 52, at 984.

owner-employees who hide behind multiple tiers of passthrough entities to shield active business income from all employment taxes. Although the existing approach of section 1411 is underinclusive and needlessly complex,[202] the fundamental goal of achieving parity in the taxation of earned and unearned income, for purposes of Medicare financing, has become increasingly urgent. The proposed approach would greatly curtail opportunities to structure Excluded Businesses in a manner that avoids all three of the 3.8% taxes and produces massive revenue loss. Employment-tax avoidance techniques rooted in business owners' hostility to the uncapping of the Medicare tax in the 1990s would no longer yield the sought-after tax benefits. Equally importantly, an expanded section 1411 would prevent wealthy passthrough owners who receive a disproportionate share of capital income from shifting the burden of Medicare taxes increasingly to employees subject to FICA and further undermining the system of mandatory social insurance.

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202. *See* NYSBA 2013 Report, *supra* note 40, at 60 (noting that I.R.C. § 1411 "is now one of the most complex provisions in the Code" and questioning whether "Congress intended" such complexity).