TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE "AMERICAN JOBS AND CLOSING TAX LOOPHOLES ACT OF 2010," FOR CONSIDERATION ON THE FLOOR OF THE HOUSE OF REPRESENTATIVES

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

May 28, 2010
JCX-29-10

The provisions relating to dispositions of partnership interests and distributions of partnership property apply to dispositions and distributions after December 31, 2010.

The provision relating to other income and gain is effective on December 31, 2010.

The rule that income from an investment services partnership interest is not qualifying income of a publicly traded partnership under section 7704 applies to taxable years of the partnership beginning on or after the date that is 10 years after the date of enactment.

2. Employment tax treatment of professional service businesses (sec. 413 of the bill and 1402(m) of the Code)

Present Law

In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[687] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[688]

FICA

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[689] The amount of wages subject to this component is capped at $106,800 for 2010. Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.

SECA

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent and the amount of earnings subject to this component is capped at $106,800 for 2010. Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped.

For SECA tax purposes, net earnings from self-employment means the gross income derived by an individual from any trade or business carried on by the individual, less the

[687] *See* Chapter 21 of the Code.

[688] Sec. 1401.

[689] Secs. 3101 and 3111.

deductions attributable to the trade or business that are allowed under the self-employment tax rules.[690] Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

Unearned income Medicare contribution

For taxable years beginning after 2012, in the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.[691] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Net investment income is investment income reduced by the deductions properly allocable to such income. Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply), (ii) other gross income derived from any business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)).

For purposes of the provision, net investment income does not include amounts subject to SECA tax. Thus, for example, in the case of a partner, the tax does not apply to any item taken into account in determining self-employment income for the taxable year on which tax is imposed under the self-employment tax rules.

S corporation shareholders

[690] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

[691] The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

An S corporation is treated as a passthrough entity for Federal income tax purposes. Each shareholder takes into account and is subject to Federal income tax on the shareholder's pro rata share of the S corporation's income.[692]

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages from the S corporation.

A shareholder of an S corporation generally is not subject to FICA tax on amounts that are not wages, such as the shareholder's share of the S corporation's income. Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized by the taxpayer as other than wages. Case law has addressed the issue of whether amounts paid to shareholders of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[693]

In cases addressing whether payments to an S corporation shareholder were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[694] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[695] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[696] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[697]

---

[692] Sec. 1366.

[693] See the discussion of case law in, e.g., Richard Winchester, *The Gap in the Employment Tax Gap*, 20 Stanford Law and Policy Review 127, 2009; James Parker and Claire Y. Nash, *Anticipate Close Inspection of Closely Held Company Pay Practices - Part I*, 80 Practical Tax Strategies 215, April 2008; *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[694] *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[695] See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

[696] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[697] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 (9th Cir. 2004) at 10-11, the Ninth Circuit noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits

Partners

A partnership is treated as a passthrough entity for Federal income tax purposes. Each partner includes in income its distributive share of partnership items of income, gain and loss.[698]

A partner's distributive share of partnership items is not treated as wages for FICA tax purposes. A partner who is an individual is subject to the SECA tax on his or her distributive share of trade or business income of the partnership. The net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership (excluding specified types of income, such as rent, dividends, interest, and capital gains and losses, as described above[699]). This rule applies to individuals who are general partners.

An exclusion from SECA applies for limited partners of a partnership.[700] Specifically, in determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.[701]

The owners of a limited liability company that is classified as a partnership for Federal tax purposes are treated as partners for tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.

Explanation of Provision

Treatment of S corporation shareholders

---

that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996). In determining whether compensation is reasonable, the U.S. Tax Court has applied the multi-factor test viewed through the lens of an independent investor where a case is appealable to a U.S. Court of Appeals which has neither adopted nor rejected the independent investor test. See *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo. 2005-243, 90 T.C.M. 399 (2005), at footnote 9; *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114, 89 T.C.M. 1279 (2005).

[698] Secs. 701, 702.

[699] Sec. 1402(a).

[700] Sec. 1402(a)(13).

[701] In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules. Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997). These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year. However, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been issued to date.

Under the provision, in the case of a disqualified S corporation, a shareholder who provides substantial services with respect to certain professional service businesses takes into account for SECA tax purposes his or her pro rata share of S corporation income or loss described in section 1366 that are attributable to the business.

As under the present-law self-employment tax rules in the case of a trade or business carried on by a partnership, certain items of income or loss are excluded from net earnings from self-employment of an S corporation shareholder under the provision, such as certain rental income, dividends and interest, and certain capital gains and losses.

Any wages of the shareholder from the disqualified S corporation are subject to FICA tax as under present law, and FICA withholding requirements apply as under present law.

A disqualified S corporation means (1) an S corporation that is a partner in a partnership that is engaged in a professional service business if substantially all of the S corporation's activities are performed in connection with the partnership, and (2) any other S corporation that is engaged in a professional service business if the principal asset of the business is the reputation and skill of three or fewer employees. It is intended that an employee include an individual who is considered an employee for Federal tax purposes.

For example, assume that an S corporation's stock is owned by a group of architects. The S corporation becomes a partner in a partnership that is formed to enter a competition to design a particular building. The other partners are architects that are not owners of the S corporation. The partnership wins the competition and the partners, including shareholders of the S corporation, perform architectural services for 18 months in connection with the construction of the building that was the subject of the competition. At the same time, the S corporation provides architectural services with respect to the design and construction of several other buildings. At the end of the 18 months, the partnership is terminated. The S corporation is not a disqualified S corporation because substantially all its activities are not performed in connection with the partnership.

As another example, assume that two lawyers, Smith and Jones, form a law firm that specializes in criminal defense work. After several years of practice, Smith and Jones have each successfully defended a number of cases and the firm has hired associate lawyers and support staff to handle the cases brought to the firm based on Smith's and Jones' reputation and skill. In this situation, the principal asset of the business is the reputation and skill of Smith and Jones.

Under the provision, for SECA tax purposes, a shareholder's pro rata share of S corporation income or loss described in section 1366 that is attributable to the professional service business includes the pro rata share of each member of that shareholder's family of such items of income or loss of the S corporation. This rule applies if the family member does not provide substantial services with respect to the professional service business. For this purpose, family members are an individual's spouse, parents, children and grandchildren. [702]

[702] A family member for this purpose is determined under the rules of section 318(a)(1), which identifies the individual's (1) spouse (other than a spouse who is legally separated from the individual under a decree of

Thus, for example, assume an individual owns 4 percent of the stock of an S corporation, and provides substantial services with respect to a medical professional service business engaged in by a partnership in which the S corporation is a partner. The individual's spouse, who provides no services with respect to the business, owns the other 96 percent of the stock of the S corporation. Under the provision, the service-providing shareholder includes in net earnings from self-employment his own pro rata share, and also the spouse's pro rata share of items of income or loss described in section 1366 that are attributable to the professional service business.

It is intended that a partnership or S corporation be considered as engaged in a professional service business if it, or a lower-tier entity, is engaged in the business. Thus, in the foregoing example, if the medical professional service business is conducted in a lower-tier partnership in which the S corporation has an interest through tiers of partnerships, the result is the same under the provision. It is intended that, under regulatory authority set forth in the provision, the Treasury provide prompt guidance to this effect. However, in the absence of guidance, it is intended that the provision be applied and interpreted in this manner.

A professional service business for this purpose means a trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

Treatment of partners

Under the provision, the exclusion from SECA for a limited partner's distributive share of partnership income or loss does not apply to any partner who provides substantial services with respect to a professional service business in which the partnership is engaged. The present-law rule for general partners applies to such a partner for determining net earnings from self-employment. The partner takes into account for SECA tax purposes his or her distributive share (whether or not distributed) of partnership income or loss (including separately stated items). As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner, such as certain rental income, dividends and interest, certain gains, and other items.

A professional service business for this purpose means a trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, or brokerage services.

Regulatory authority

Treasury regulatory authority is provided to carry out the purposes of the provision, including by prescribing guidance to prevent the avoidance of the purposes of the provision through tiered entities or otherwise. It is intended that guidance be provided promptly to

---

divorce or separate maintenance), and (2) his or her children, grandchildren and parents. For this purpose, a legally adopted child is treated as a child by blood.

determine how taxpayers include amounts in net earnings from self-employment in situations in which multiple family members provide substantial services and multiple family members who do not provide substantial services are entitled to a pro rata share of items of income or loss of a S corporation.

Effective Date

The provision is effective for taxable years beginning after December 31, 2010.