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# Less Is More: Applying a Modified Reasonable Compensation Standard to Eliminate the Inconsistencies Among the Payroll Tax Bases and the Net Investment Income Tax Base Under the Affordable Care Act

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## I. INTRODUCTION

The original policy for the implementation of payroll taxes was to impose a tax on wages as both a funding mechanism for, and a limitation to, qualifying for social security. However, the self-employment tax base developed severe inconsistencies with this original policy and among different tax entities by including certain returns on capital investments in the tax base. At present, different payroll tax obligations arise for similarly situated taxpayers based solely on how business owners elect to be taxed under the check-the-box regulations. These inconsistencies resulted from misguided efforts by Congress and the Treasury to view the payroll tax base with the same lens as the income tax. This misconception is evident in regulations and proposals that seek to distinguish wages from capital for purposes of payroll taxes based on the active/passive distinction that arose under the passive loss limitation rules of the income tax.

Following the lead of the self-employment tax base, the newly minted net investment income tax base that arose under the Affordable Care Act now suffers from similar inconsistencies.[1] Consequently, certain capital income for active members of tax partnerships is included in the self-employment tax base, and this same income for shareholders of S corporations is neither taxed as self-employment income nor taxed under the net investment income tax regime. Also, owner–employees are entitled to significant reductions in their payroll tax obligations when the value of their services provided to the company exceeds their share of the income from the company. This reduction is never recaptured even if the company becomes very profitable in subsequent years. The net investment income tax takes effect for the first time in 2013,[2] and there are currently pending legislative proposals that seek to merge the income tax provisions for the various flow-through entities under one standardized set of rules.[3] So the time is ripe to eliminate the various inconsistencies in the payroll tax and net investment income tax by using a uniform standard consistently applied across all entities and taxpayers.

This Article makes four recommendations to restore the payroll tax regime to its original purpose and cure these inconsistencies in the payroll tax and net investment income tax bases. First, payroll taxes should be standardized for all taxpayers across all tax entities by using the reasonable compensation standard so that capital income is entirely eliminated from the payroll tax base. Second, the Treasury

1. Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411, 124 Stat. 1029, 1061.
2. *Id.*
3. *See, e.g.*, S Corporation Modernization Act of 2013, H.R. 892, 113th Cong. (2013); Job Preservation and Economic Certainty Act of 2013, S. 277, 113th Cong. (2013); Balancing Act, H.R. 505, 113th Cong. (2013).

should issue additional significant regulations to improve the administration of the reasonable compensation standard, including providing safe harbor amounts that can be claimed as reasonable compensation for the value of services provided by owner–employees based on the average remuneration paid to similarly situated non-owner taxpayers. Third, to the extent that the owner–employee's share of income for the year is less than the value of services provided to the company, such deficiency should be carried forward for up to three future tax years and applied to increase the payroll tax base of the owner–employee to the extent that the owner–employee's share of income exceeds the value of services provided in such later years. Finally, the definition for net investment income for purposes of the net investment income tax, a tax which is specifically meant to apply to returns on capital, should be modified to simply include all items of income that are not otherwise subject to the payroll tax base as wages.

Since the proper implementation of these recommendations would require congressional action and the motivation for such changes is to restore the payroll tax base to its original foundation rather than to cut taxes or raise revenues, these changes should be made on as close to a revenue-neutral basis as possible. After taking the projected revenue adjustments in the payroll and net investment income taxes along with the projected adjustments to future outlays within the relevant budget window, the tax rates could be adjusted downward to the extent the changes increase net revenues or upward should these changes result in a decrease in net revenues. These changes would reacquaint payroll taxes with the original policy for the social security tax and benefit system—namely, that it be based on the wages of wage earners rather than capital income—and would eliminate the arbitrary variance in the self-employment and net investment income tax bases between identical business activities of owners of different flow-through entities.

## II. FICA AND SECA TAXES IN A NUTSHELL

The Federal Insurance Contributions Act (FICA) imposes a tax on both employees and employers on most wages paid to an employee with respect to employment.[4] Subject to a few limited exceptions,[5] the

4. *See* I.R.C. § 3101 (2012) (setting Old Age, Survivors, and Disability Insurance (OASDI) on wages for the employer and the employee, respectively, at 6.2% from 1990 forward for most wages except for wages subject to international agreements); I.R.C. § 3121(a) (2012) (defining "wages" broadly as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash," subject to certain stated limitations).

5. I.R.C. § 3111(d) (2012) (noting a few limited exceptions where wages are not included in the tax base for FICA including, by way of example, wages paid to students by universities, certain wages paid to qualified veterans and a special exemption for certain individuals hired in 2010 that was part of the Tax Relief,

vast majority of wages paid to employees are subject to FICA tax, and employers are required to deduct and withhold the employee's FICA tax obligation.[6] Income paid to owner–employees in exchange for services provided to the company are subject to self-employment tax pursuant to the Self Employment Contributions Act (SECA), although the SECA tax base also includes certain types of capital income.[7]

The rate of tax on includible wages that applies both to the employer and the employee is 7.65%. This is made up of a tax to support old age, survivors, and disability insurance—the social security portion—in the amount of 6.2%[8] and hospital insurance—the Medicare portion—in the amount of 1.45%.[9] The social security portion applies only to income below the wage base limit,[10] which was $113,700 in 2013,[11] while the Medicare portion applies to all qualified wages.[12] So, collectively, the employer and employee in 2013 combine to pay 15.3% in FICA taxes due on the first $113,700 of income and 2.9% on all wages thereafter, subject to an additional tax under the Affordable Care Act on earnings exceeding a certain threshold.[13] Notwithstanding occasional rate changes,[14] base increases,[15] and temporary reductions,[16] the overall scheme for FICA taxes has remained relatively stable over the years since its initial enactment in the 1930s.

Under the Affordable Care Act there is an additional Medicare tax of .9% on earnings in excess of $200,000 for unmarried taxpayers, $250,000 for married filing jointly taxpayers, and $125,000 for mar-

Unemployment Insurance Reauthorization, and Job Creation Act of 2010); *Payroll Tax Cut to Boost Take-Home Pay for Most Workers; New Withholding Details Now Available on IRS.gov*, INTERNAL REVENUE SERV. (Dec. 17, 2010) [hereinafter *Payroll Tax Cut*], http://www.irs.gov/uac/Payroll-Tax-Cut-to-Boost-Take-Home-Pay-for-Most-Workers%3B-New-Withholding-Details-Now-Available-on-IRS.gov.

6. I.R.C. § 3102(a) (2012).
7. *See* discussion *infra* section IV.A.
8. The "old-age, survivors and disability insurance" portion is commonly known as either OASDI or the social security portion and will hereinafter be referred to by the latter term.
9. *See* I.R.C. § 3111(a)–(b).
10. *See* I.R.C. § 3121(x).
11. INTERNAL REVENUE SERV., PUBLICATION 15, (CIRCULAR E), EMPLOYER'S TAX GUIDE 1 (2013), *available at* http://www.irs.gov/pub/irs-pdf/p15.pdf.
12. SOC. SEC. ADMIN., UPDATE 2013 (2013), *available at* http://www.ssa.gov/pubs/10003.html#a0=0.
13. *See* I.R.C. § 3101(b)(2) (2012); Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §§ 9015, 10906, 124 Stat. 119, 870, 1020 (2010).
14. I.R.C. § 3111(a).
15. *Contribution and Benefit Base*, SOC. SEC. ADMIN., http://www.ssa.gov/oact/COLA/cbb.html#Series (last visited Aug. 24, 2013) (displaying the increase in contribution and benefit bases from 1937–2013); *see* 42 U.S.C. § 430 (2006).
16. Middle Class Tax Relief and Job Creation Act of 2012, Pub. L. No. 112-96 § 1001, 126 Stat. 156, 158–59; Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 § 601(c), 124 Stat. 3296, 3309; *Payroll Tax Cut*, *supra* note 5.

ried filing separately taxpayers, bringing the tax on such earnings to 3.8%.[17] There is also a corresponding tax of 3.8% on the lesser of an individual's unearned income or income in excess of these threshold amounts, called the net investment income tax.[18]

Under SECA, self-employed individuals get the privilege of paying both the employer and employee aspects of the FICA tax regime and, as such, are taxed on wages at 15.3% up to the wage base limit.[19] Wages in excess of this amount are taxed at 2.9% up to the threshold income level activating the additional tax under the Affordable Care Act where the tax then increases to 3.8%.[20] However, one-half of the SECA taxes paid are deductible as a business deduction on the individual's tax return.[21] This was meant to ensure that the tax on self-employed individuals was essentially the same as the combination of payroll taxes paid by employed individuals and their employers with the corresponding deduction for the employer.[22] However, this effort was not entirely successful because of variance in the FICA and SECA tax bases across different flow-through entities, particularly in regard to capital.[23]

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17. *See* Patient Protection and Affordable Care Act §§ 9015, 10906; Healthcare and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411, 124 Stat. 1029, 1061; CONG. BUDGET OFFICE, Pub. No. 4168, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX 1 n.2 (2012) [hereinafter CONG. BUDGET OFFICE], *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/09-27-SECA.pdf.

18. I.R.C. § 1411(a) (2012); Treas. Reg. § 1.1411-2 (2013). It should be noted that this is not an exhaustive list of the taxes and fees under the Affordable Care Act but is limited to the taxes designed in the same mold as FICA and SECA taxes and affected thereby. Apart from the additional Medicare tax on wages and the tax on net investment income, some of the better-known taxes under the Affordable Care Act include: a new medical device tax under section 4191; a 40% tax on the excess benefit of certain employer-sponsored plans, or so called Cadillac plans, under section 4980I; an increase of the adjusted gross income floor for itemized medical expense deductions from 7.5% to 10% under section 213; a tax on indoor tanning services under section 5000B; and limitations of the deduction for compensation paid by certain health insurance providers under section 162(m). Also, the individual mandate under section 5000A is itself a form of taxation pursuant to Chief Justice Roberts's majority opinion upholding the Affordable Care Act. National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566, 2594 (2012).

19. *See* I.R.C. § 1401(a)–(b) (2012) (setting self-employment OASDI at 12.40% starting in 1990 and hospital insurance at 2.9% starting in 1986).

20. *See* I.R.C. § 1401(b)(2)(A); CONG. BUDGET OFFICE, *supra* note 17.

21. I.R.C. § 164(f) (2012).

22. *See* Patricia E. Dilley, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 Tax Law. 65, 74–75 (2000).

23. *See* discussion *infra* section IV.C.

## III. THE POLICY FOR THE LAST GREAT "REGRESSIVE" AND "FLAT" TAXES

If considering the tax burden alone, then the social security portion of payroll taxes is arguably one of the few regressive tax regimes[24] remaining in the United States and the hospital insurance is one of the few remaining flat taxes. However, taking both the direct benefits and direct burdens of the payroll taxes into consideration reveals that they are actually also progressive in nature. As Nancy J. Altman explains, social security taxes are actually progressive because the benefit formula was designed "to redistribute from those with higher wages over their careers to those with lower wages."[25] When social security is viewed as wage insurance where the benefits are tied to the amount of wages subject to the tax rather than a benefit that is redistributed among the population generally, then social security payments look a lot more like policy premiums or even contributions to a retirement plan than "mere taxes."[26] Indeed, this position is perfectly consistent with the way the payroll tax was viewed when originally passed notwithstanding the subsequent decoupling of benefits and burdens introduced when the Medicare portion was added.

A different view under the benefits principle may be that the receipt of benefits in proportion to the taxes paid is actually wholly consistent with a progressive income tax or a progressive wealth tax regime since the greater the income or wealth, the greater the benefit derived from the public goods and services supported by income and wealth taxes. However, to the extent that the law of diminishing returns applies to such benefits, then the benefits principal in the context of a wealth tax would only support either a tax at a diminishing marginal rate or, at most, a flat tax.[27] Furthermore, absent a direct

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24. Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 864 (1987); Willard Taylor, *Payroll Taxes—Why Should We Care? What Should Be Done?*, 137 TAX NOTES 983 (2012).
25. Nancy J. Altman, *The Striking Superiority of Social Security in the Provision of Wage Insurance*, 50 HARV. J. ON LEGIS. 109, 118–19 (2013). Additionally, the earned-income credit ("EIC") may call into question the "flat" and "regressive" nature of payroll taxes as the EIC provides a refundable credit of up to $5,891 that phases out with increasing income levels. *See* INTERNAL REVENUE SERV., 2012 EARNED INCOME CREDIT TABLE 56–72 (2012), *available at* http://www.irs.gov/pub/irs-dft/i1040tt—dft.pdf (providing that the EIC cancels out entirely for single individuals with no children at $13,950 and $50,270 for married filers with three or more qualified children). While incorporating the EIC, an income tax-based credit, into the payroll tax argument may admittedly be comparing apples to oranges, this distinction makes little difference from the taxpayers point of view where the payroll taxes, SECA, and income taxes are all filed on the same income tax return.
26. Altman*, supra* note 25, at 116.
27. Eric Rakowski, *Can Wealth Taxes Be Justified?*, 53 TAX L. REV. 263, 308 (2000) (noting that the benefit principle may justify a wealth tax, but only if it were

measurable benefit, the benefits approach may prove an entirely unworkable framework for setting tax policy, as its pure implementation in the wealth tax context could arguably lead to a head tax.[28] But the very reason why the application of the benefits principle may be unworkable in the context of an income or wealth tax is why the benefits principle is perfectly appropriate in the context of the payroll tax—namely because a participant's benefits are tied to the amount of wages subject to payroll taxes and are also very easily quantified in the form of future social security and Medicare benefits.

### A. Legislative History Illustrates the Critical Differences Between the Policy for Payroll Taxes and Income Taxes

The original policy for the social security tax supports the view that payroll taxes are really meant to approximate retirement and disability insurance policy premiums rather than serve as taxes, particularly when contrasted with the original policy for the income tax. The history of the Social Security Act of 1935 bears this out, especially how the program was viewed by its primary proponents, Franklin D. Roosevelt (FDR) and Eleanor Roosevelt. The idea for social security originated with FDR's pension plan enacted in New York while governor,[29] but social security was seen as a significant improvement upon this initial version. In fact, Eleanor Roosevelt viewed the fact that the New York pension plan relied upon annual appropriations as a key weakness in the plan and proposed that a more robust plan would depend on contributions made to the plan over the working life of each participant.[30] Indeed, FDR's statement upon the passage of the Social Security Act of 1935 focused on the idea that payments into social se-

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applied at flat or diminishing marginal rates, which is inconsistent with current wealth taxes).

28. *See, e.g.*, Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 TAX L. REV. 423, 458 (2000) (asserting that the benefits principle is not a workable approach for calculating indirect benefits received by all taxpayers and that, ignoring such limitations, applying the benefits principle would lead to the imposition of a head tax imposed on persons without regard to their ability to pay).

29. *Our Documents: The Social Security Act,* FRANKLIN D. ROOSEVELT PRESIDENTIAL LIBR. & MUSEUM, http://docs.fdrlibrary.marist.edu/odssa.html (last visited Aug. 22, 2013); *see also* Eleanor Roosevelt, *Old Age Pensions: A Speech Before the D.C. Branch of the American Association for Social Security, the Council of Social Agencies, and the Monday Evening Club*, ELEANOR ROOSEVELT PAPERS PROJECT (Feb. 8, 1934), http://www.gwu.edu/~erpapers/documents/articles/oldagepensions.cfm (discussing the New York and Massachusetts pensions in effect at the time, the Washington, D.C. legislation that was up for adoption, and her view that the D.C. law would be a "model" and that "the eyes of the nation [would] be focused on it").

30. Roosevelt, *supra* note 29 (noting that a more robust system than the New York and Massachusetts pensions, which required annual appropriations, would be for the plan to "depend, when [it] becomes universal, on some method of insurance—

curity represented either payments for disability insurance or contributions to a retirement plan.[31]

The concept of a trust fund holding the contributions to social security, in stark contrast to the taxation and appropriation regime, was a critical element to insulate social security from the variance inherent in the business cycle,[32] as well as the political whims of the day.[33] In fact, one of the reasons social security contributions and participation were based on wages was to give participants a "legal and moral right" to collect what FDR referred to as the social security "pension."[34] According to *Flemming v. Nestor*, this right to social security benefits is not actually a legal right,[35] but it remains a substantial perceived and political right for many lay people who commonly take issue with the technical characterization of social security as an entitlement,[36] a position which has garnered sympathy from at least one sophisticated legal commentator.[37] FDR's vision proved prophetic as, even now, nearly eighty years later, the rights to social security benefits are deemed so sufficiently certain from a political perspective that the Congressional Budget Office (CBO) as a matter of course includes the outlays and deficiencies in the social security trust funds in its

some fund which is paid into over a whole period of a person's life, or earning life at least")

31. *Franklin Roosevelt's Statement on Signing the Social Security Act*, FRANKLIN D. ROOSEVELT PRESIDENTIAL LIBR. & MUSEUM (Aug. 14, 1935), http://docs.fdrlibrary.marist.edu/odssast.html (referring to the retirement aspects of the act as "old-age pensions" and the act as a whole as an insurance).
32. *Id.* (stating that the structure of the social security act would lessen "the force of possible future depressions" and protect future administrations from "going deeply into debt to furnish relief to the needy").
33. Patricia E. Dilley, *Through the Doughnut Hole: Reimagining the Social Security Contribution and Benefit Base Limit*, 62 ADMIN. L. REV. 367, 387 n.63 (2010) (citing Senator Moynihan's account of a meeting with President Roosevelt wherein FDR stated that payroll tax contributions were meant to "give the contributors a legal, moral, and political right to collect their pension and their unemployment benefits" so that "[n]o damned politician can ever scrap my Social Security Program").
34. *Id.*
35. Flemming v. Nestor, 363 U.S. 603, 611 (1960) (holding that recipients have no actual contractual right to social security benefits based on payments).
36. *See, e.g.*, Peter Breskovich, Letter to the Editor, *Social Security Not an 'entitlement,'* STANDARD-EXAMINER, Mar. 4, 2013, http://www.standard.net/stories/2013/03/04/social-security-not-entitlement; Katie Glueck, *AARP's Barry Rand: Mend, Don't End Entitlements*, POLITICO (Jan. 15, 2013, 12:16 PM), http://www.politico.com/story/2013/01/aarp-mend-dont-end-entitlements-86217.html.
37. Brendan S. Maher, *The Benefits of Opt-in Federalism*, 52 B.C. L. REV. 1733, 1749 n.80 (2011) (citing Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 HOFSTRA LAB. & EMP. L.J. 263 (2011)) (noting that, while social security is technically an entitlement for federal budgeting purposes, "one view may be that an entitlement is an unconditional moral right; under that definition, Social Security is not an entitlement, because it has conditions").

calculations and future projections of the federal deficit.[38] Additionally, as various other federal programs have been carried lifeless off the battlefield of budget cuts, scaled back by sequesters, or deemed non-essential during government shutdowns, the social security program has exhibited enormous staying power by surviving such recent fights mostly unscathed.

Given the initial structure and policy for social security, the contributions to social security were appropriately viewed as a hybrid of disability insurance and unemployment insurance payments, as well as contributions to a retirement plan, rather than as a tax.[39] The justification for the regressive nature of payroll taxes was, in fact, that they were never meant to be viewed as taxes at all. The benefits of social security were directly tied to the individuals who paid into the system, and participation was only extended to the wage earners rather than investors of capital.[40] Participation in social security was viewed as a good deal for the participants because they were expected to receive significantly more in benefits on a net present value basis than they contributed to the program,[41] which held true for more than fifty years from 1935 through at least 1985.[42] This is why Congress sought to prevent individuals who did not need social security from participating in the program.[43] In fact, in 1951 when the then 1.5% payroll tax was expanded to include a 2.5% tax on self-employed individuals, it was done primarily so that these individuals could participate in the benefits of the social security program—not as a source of additional revenue.[44]

In stark contrast to payroll taxes, there is no moral or political correlation between paying income taxes and the receipt of any nonpublic specific benefit. Income taxes are deemed an appropriate duty incident to the benefits of participating in income-earning opportunities in the United States that are available to society in general. This underlying policy for the income tax was articulated prior to the passage

38. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2013 TO 2023, at 15 (2013), *available at* https://www.cbo.gov/sites/default/files/cbofiles/attachments/43907-BudgetOutlook.pdf.

39. *See* Dilley, *supra* note 33, at 385–87.

40. Dilley, *supra* note 22, at 70–71.

41. Dilley, *supra* note 33, at 287 (citing REPORT OF THE SOCIAL SECURITY BOARD, H.R. DOC. NO. 76-110, at 5 (1939), *available at* http://www.ssa.gov/history/reports/38ssbadvise.html) ("[E]very worker, regardless of his level of earnings or of the length of time during which he has contributed, will receive more by way of protection than he could have purchased elsewhere at a cost equal to his own contributions.").

42. Stephen Ohlemacher, *Is Social Security Still a Good Deal for Workers?*, YAHOO! NEWS (Aug. 5, 2012), http://news.yahoo.com/social-security-still-good-deal-workers-125016929—finance.html.

43. Dilley, *supra* note 22, at 74.

44. *Id.*

of the Sixteenth Amendment,[45] and it provides a stark contrast to the policy for the payroll tax in terms of the linkage between its benefits and burdens, namely, that there is no such linkage. In the Supreme Court's watershed, and greatly maligned, ruling in *Pollock v. Farmers' Loan & Trust Company*, the then-existing income tax on interest, dividends, and rents was deemed unconstitutional as an unapportioned direct tax in violation of Article I, Section 2 of the U.S. Constitution.[46] The U.S. Constitution originally contemplated taxes in three categories—only the second of which was free from the requirement to be apportioned to the several states based on population—(i) direct taxes, (ii) duties, imposts, and excises, and (iii) the capitation tax.[47] Congress responded directly, albeit belatedly,[48] to *Pollock* with the passage of the Sixteenth Amendment, eliminating the apportionment requirement as to direct taxes.

President Taft addressed the Senate and the House of Representatives on June 16, 1909, with a special message recommending passage of the Sixteenth Amendment to Congress.[49] In Taft's inaugural address in 1909, he had stated that new forms of taxation were needed to address the rapidly increasing deficit, including a possible graduated inheritance tax, particularly if the then-proposed tariff bill secured inadequate revenues.[50] Since it was evident by that summer that the Senate would not support the inheritance tax, Taft proposed a general income tax in the form and character previously struck down in *Pollock*, but he did so this time via a constitutional amendment to avoid a fate similar to the prior income tax law.[51] Having lifted the apportionment requirement as to Congress's power "to collect taxes on incomes, from whatever source derived,"[52] the Sixteenth Amendment granted plenary power, or significantly unlimited power, to the federal

45. It should be noted the Sixteenth Amendment was merely the re-birth of the income tax, which had passed in 1894 as a basis for the decision in *Pollock v. Farmers' Loan & Trust Company*, 157 U.S. 429 (1895) *aff'd*, 158 U.S. 601 (1895), and also existed during the Civil War. *See* Ellen Terrell, *History of the US Income Tax, Business Reference Services*, LIBR. CONGRESS (Feb. 2004), http://www.loc.gov/rr/business/hottopic/irs_history.html.

46. *Pollock*, 157 U.S. 429 (1895), *aff'd*, 158 U.S. 601 (1895).

47. Edward B. Whitney, *The Income Tax and the Constitution*, 20 HARV. L. REV. 280, 280 (1905) (internal quotations omitted).

48. It took more than fourteen years from the *Pollock* decision to enact the Sixteenth Amendment in 1909, and the Amendment wasn't ratified by the states until 1913. U.S. GOV'T. PRINTING OFFICE, AMENDMENTS TO THE CONSTITUTION OF THE UNITED STATES OF AMERICA 33 n.8, *available at* http://www.gpo.gov/fdsys/pkg/GPO-CONAN-1992/pdf/GPO-CONAN-1992-7.pdf (last visited Aug. 23, 2013).

49. 45 CONG. REC. 3344–45 (1909)

50. *Id.*; President William Howard Taft, Inaugural Address (Mar. 4, 1909).

51. Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes,"* 33 ARIZ. ST. L.J. 1057, 1108 (2001).

52. U.S. CONST. amend. XVI.

government over the use of funds derived from the income tax.[53] So the income tax was implemented to raise funds to cover the general expenses of the federal government that contribute to the deficit in whatever form these expenses may take.[54]

In summary, the underlying policies for payroll taxes and income taxes are completely different. There was a clear intention that the use of funds from the income tax be entirely decoupled from the source of those funds. It was never intended that taxpayers would receive specific benefits based on whether they paid income taxes or on their amount of income subject to tax. The payroll taxes, on the other hand, were initially levied for the specific purpose of providing social security *directly to* the contributors and in amounts that were based *directly on* the amount of wages included in the payroll tax base. As such, this author rejects the argument that the social security portion of the payroll tax is an improper regressive tax indistinguishable from the income tax as well as the related assertion that payroll taxes should simply be collapsed into the income tax base in order to correct this perceived flaw.[55] To the contrary, the social security portion of the payroll tax is more appropriately viewed as a retirement and disability insurance premium and not as a tax at all. The original policy for the payroll tax, including its originally intended structure, remains highly relevant today—both as a safeguard for the benefits granted thereunder and as a proper metric for assessing the merit of any proposed changes to the payroll tax system.

### B. The Subsequent Decoupling of the Payroll Tax Benefits and Burdens Through the Passage of Medicare Changed the Character and Perception of Payroll Taxes to More Closely Approximate the Income Tax Regime Than Was Originally Intended

When Medicare was initially passed in 1965,[56] the program used the payroll tax base as a tax on wages but assessed tax on all wages

53. Jensen, *supra* note 51, at 1058.

54. Furthermore, it is generally agreed that the Sixteenth Amendment to the U.S. Constitution "does not significantly constrain how taxable income can be defined by Congress and the courts." *Id.* at 1059 (quoting Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 TAX L. REV. 707, 711 n.17 (1990)); Ruth Mason, *Federalism and the Taxing Power*, 99 CAL. L. REV. 975, 995 (2011) (noting that modern decisions may tentatively support the position that the Taxing and Spending Clause to the U.S. Constitution "would allow Congress to use its taxing power, like its spending power, to regulate areas that it may not regulate directly.").

55. *See* Taylor, *supra* note 24, at 983.

56. Dean M. Harris, *Beyond Beneficiaries: Using the Medicare Program to Accomplish Broader Public Goals*, 60 WASH. & LEE L. REV. 1251, 1287 (2003).

rather than just wages up to the wage base limit.[57] The initial .35% Medicare Hospital Insurance was implemented for both employed and self-employed taxpayers.[58] Medicare benefits generally flow equally to all citizens or permanent residents of the United States who are sixty-five years or older and who worked for at least forty quarters, or ten years, in Medicare-covered employment.[59] Unlike the social security benefit, which is based on the level of wages subject to social security tax, Medicare benefits are provided equally to individuals and spouses meeting the forty-quarter requirement without any regard to the level of wages that were subject to the payroll tax. Therefore, the Medicare portion of payroll taxes significantly—although not entirely—decoupled the benefit for burden quid-pro-quo that exists for the social security portion of the tax. This decoupling pushed the functional nature of payroll taxes in the direction of income taxes levied to fund a general benefit for society, as opposed to contributions for a defined benefit or insurance premiums. The Medicare portion of the payroll tax better supports the position that the payroll tax is merely a flat tax on income that manages to hang on as a function of low salience. But even though Medicare is a flat tax based on wages, the benefits are progressive because low wage earners receive the same benefits as high wage earners. Additionally, the functional nature of the Medicare portion places it somewhere in between the policy for the social security tax and the policy for the income tax. This is because eligibility for Medicare is still premised on a degree of participation, however slight, in bearing the burden for the program based on the forty-quarter requirement, but the connection between the benefits and burdens is significantly less direct than for the social security portion.

## IV. THE SECA AND FICA TAX BASES VARY FOR SELF-EMPLOYED INDIVIDUALS OWNING DIFFERENT ENTITY TYPES AND EMPLOYEES AND FAILS TO COMPLY WITH THE ORIGINAL POLICY FOR THE PAYROLL TAX REGIME

### A. The SECA Tax Base Includes Capital Income

There is a different tax base under SECA than FICA because, in addition to taxing the wages of the business owner, SECA also taxes capital in certain circumstances.[60] Congress's apparent intent was for the SECA tax base to precisely mirror the FICA tax base to extend social security and Medicare benefits to self-employed individuals

57. Social Security Amendments of 1965, Pub. L. No. 89-97, § 1817, 79 Stat. 286, 299.
58. *Id.* §§ 1401, 3101.
59. Carsten A. Peterson, *New Twist to an Old Injustice—Genetic Discrimination and Medicare Reform*, 36 IDAHO L. REV. 345, 355 n.81 (2000).
60. *See* CONG. BUDGET OFFICE, *supra* note 17, at 1–3.

through the taxation of "remuneration from one's own labor."[61] However, the way the tax base was actually defined by Congress included, potentially inadvertently, income from capital from unincorporated businesses.

The SECA base is based on the self-employed individual's distributive share of net income from a trade or business carried on as a partnership or guaranteed payments to a limited partner performing services for the partnership.[62] The definition does specifically exclude several important capital income items including rent income from real and personal property; dividends from stocks and bond interest; gains and losses from capital assets, timber, and mining; and certain involuntary conversions of capital assets,[63] but other forms of capital income are included in the base. The 2012 CBO report on the taxation of labor and capital through the SECA Tax described this as follows:

> Specifically, the SECA tax base can include the return on investments in tangible and intangible (but not financial) assets made by an unincorporated business. In contrast, if an incorporated business makes the same investment, the return is reflected in the company's profits, not in its employees' wages, and therefore is not included in the FICA tax base.[64]

The taxation of capital arises from returns on investments in excess of the reasonable wages of the owners of noncorporate entities on non-excluded capital income items such as intangible assets like intellectual property, goodwill, or business processes. However, the application of these returns on investment to the SECA tax base is inconsistent even among noncorporate flow-through entities.[65]

Certainly when income from self-employment was first subjected to SECA tax in 1951,[66] the concept of capital investment in intangible assets and goodwill was not as relevant as is the case today. This taxation of capital in unincorporated businesses may have been an accident of history resulting from either poor drafting or an understandable lack of foresight, but the combination of this imperfect definition with the drastic expansion of limited liability companies (LLCs) and capital investment in intangible property has greatly exacerbated what would have otherwise been a fairly minor inconsistency between the FICA and SECA tax bases. In fact, the capital portion is now estimated by the CBO at 42% of the total SECA Hospital Insurance (HI) tax base.[67]

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61. Dilley, *supra* note 22, at 74.
62. *See* I.R.C. § 1402(a) (2012). In fact, Professor Patricia Dilley explains the implementation of SECA as stretching FICA tax "beyond all recognition in the quite different context of self employment." Dilley, *supra* note 22, at 65.
63. I.R.C. § 1402(a)(1)–(3).
64. *See* CONG. BUDGET OFFICE, *supra* note 17, at 2.
65. *See* discussion *infra* section IV.B.
66. Dilley, *supra* note 22, at 74.
67. *See* CONG. BUDGET OFFICE, *supra* note 17, at VI.

### B. SECA Tax on Capital Is Inconsistently Applied to Owners of LLPs, LLCs, and S Corporations

The SECA tax base was intended to tax only wages, but the formula that was originally established to approximate wages of business owners failed to exclude all capital from taxation for unincorporated entities and also does not tax limited partners on their capital investments.[68] As a result, the SECA tax base varies depending on the form of flow-through entity the owner elects to utilize for the business operations. There may be no distinction between the actual economics of a shareholder run S corporation and a member-managed LLC, apart from a check-the-box tax election,[69] but there are very significant differences in how the capital invested in tangible and intangible assets is taxed under the self-employment payroll tax regime. The most favorable entity in many instances for purposes of reducing payroll tax liability is the S corporation because all earnings above and beyond the value of the services provided by the owner to the corporation, as determined by a reasonable compensation standard, are excluded from the payroll tax base for that owner.[70] Remuneration in excess of the reasonable compensation amount is a "distribution of profits,"[71] or a dividend that is excluded from the SECA tax base under section 1402 of the Internal Revenue Code,[72] meaning that income from investments in tangible and intangible property is not included in the SECA tax base for S corporation shareholders. It should be noted that the word "dividend" in the payroll tax context is used in a completely different manner than for income tax purposes.[73] Such dividends for S corporations are more appropriately described as distributions from profits in excess of reasonable compensation[74] and are

68. *Id.* at 1–2.
69. *See* Treas. Reg. § 301.7701-3 (as amended in 2006).
70. Martin A. Sullivan, *Economic Analysis: The Small Business Love-Hate Relationship with Corporate Tax*, TAX NOTES TODAY, Sept. 26, 2011, *available at* LEXIS, 2011 TNT 186-1.
71. *See* I.R.C. § 1402 (2012).
72. Treas. Reg. § 1.1402(a)-5(a) (1963); *see, e.g.*, Richard Winchester, *Working for Free: It Ought to Be Against the (Tax) Law*, 76 MISS. L.J. 227 (2006) (asserting that there is a "substantial economic incentive" for high-income employee–shareholders to work for free, thereby substituting SECA-free dividends for the compensation that would have otherwise been subject to SECA taxes).
73. *See* Mark S. Hoose, *Trading One Danger for Another: Creating U.S. Tax Residency While Fleeing Violence at Home*, 12 FLA. TAX REV. 827, 833 n.30 (2012) (explaining briefly the differences for income taxation of dividends for corporations as opposed to the distribution of profits for S corporations).
74. *See* Radtke v. U.S., 895 F.2d 1196, 1197 (7th Cir. 1990) (re-characterizing "dividends" from an S corporation providing professional services as wages or reasonable compensation); Rev. Rul. 74–44, 1974–1 C.B. 287 (referring to distributions of corporate profits of an S corporation as "dividends" but determining that such "dividends" were in fact reasonable compensation and, therefore, subject to SECA taxes).

not taxed as dividends for income tax purposes like dividends from corporations taxed under Subchapter C.[75]

Owners of limited liability partnerships (LLPs) are taxed under SECA in a completely different manner. LLPs were once taxed in the same manner as other tax partnerships, but in the 1970s Congress became concerned that wealthy individuals close to retirement were joining LLPs as limited partners in order to qualify for social security benefits.[76] Such participation by limited partners was deemed to be "inconsistent with the basic principle of social security—to partially replace lost earnings from work," and in response, "Congress amended Code Sec. 1402(a) in 1977 to exclude a limited partner's share of partnership income (other than for guaranteed payments received for services actually rendered). . . ."[77] As such, section 1402(a)(13) of the Internal Revenue Code provides that limited partners do not owe any payroll taxes on their respective "distributive share[s] of any item of income." This is consistent with the historical requirements that a limited partner be a passive investor and not be actively involved in the day-to-day operations of the business because such an investor would not earn wages in the traditional sense.[78]

All income received by a limited partner, other than remuneration for services and guaranteed payments, is clearly passive income derived from that partner's capital investment in the LLP and, therefore, is excludible from the SECA tax base.[79] So limited partners are

75. However, technically an S corporation can have a dividend taxed under the income tax similar to a dividend from a C corporation to the extent of remaining earnings and profits that accumulated in the corporation prior to its S election. *See* I.R.C. § 1368(c)(2) (2012).

76. Timothy R. Koski, *The Application of Self-Employment Tax to Limited Liability Companies: A Critical Analysis*, 23 J. APPLIED BUS. RES., no. 3, 2007, at 87. It is worth noting that this provides direct evidence that a significant number of individuals were actually seeking to increase their participation in the social security program by structuring their affairs in such a manner as to maximize their payroll tax liability, further demonstrating why the payroll tax is an altogether different animal than the income tax.

77. *Id.* at 87–88.

78. It is generally inadvisable for nontax reasons in an LLP for a limited partner to provide services or engage in any degree of management because too much activity in an LLP by an inactive partner may result in the limited partner being treated like a general partner and, therefore, subjected to unlimited liability. *See* Mitchell A. Stephens, *A Trap for the Rational: Simultaneous Removal and Appointment of a General Partner Under the Revised Uniform Limited Partnership Act*, 2007 UTAH L. REV. 521, 523 (2007) (noting the general principle under the Uniform Limited Partnership Act of 1916 that, in contrast to general partners, limited partners could "not incur personal liability beyond the amount of their partnership contributions," but to garner this protection, limited partners also must not take "an active role in the management of the partnership").

79. *See, e.g.*, Orly Sulami, *Good News in a Bad Economy: Service Acquiesces on Pro-Taxpayer Application of Passive Activity Loss Rules to Limited Liability Companies*, 65 TAX LAW. 81, 102–03 (2011) (noting that a potential downside to recent

essentially subject to the same rules as S corporation shareholders, but general partners of LLPs, who are not subject to the limitation under section 1402, are taxed in the same manner as partners in other tax partnerships, such as active members of LLCs.

General partners of LLPs, sole proprietors, partners, and owners of other entities taxed as partnerships, including LLCs, are governed by a completely different set of rules for determining the payroll tax base. Since LLCs and partnerships receive income in the form of distributive shares rather than receiving dividends like corporations, the distributive share of income is not specifically excluded under section 1402(a).[80] So partnerships rely on the general exclusions of certain passive income items under section 1402(a)(1)–(3), which is an incomplete list of capital income exclusions designed to avoid taxing all capital but failing to exclude income from capital invested in tangible and intangible assets.

The theories take completely different approaches as S corporations start with reasonable compensation and then assume that all other income is from the owner's capital investment in the company. The theory for LLCs and general partners is to assume all income is from wages and then exclude specific items that are generally derived from the owner's capital investment but fail to exclude all such items. Therefore, members of LLCs and general partners include more income in their SECA tax base than similarly situated shareholders of S corporations. Notwithstanding this difference, there may be significant income-tax advantages to selecting the partnership tax regime depending on the specific circumstances of the business arrangement.[81] Individuals who simply earn wages through an employer and

decisions treating LLC members as general partners for purposes of the passive activity loss rules is that the treatment "will likely increase an LLC member's [SECA] tax liability when the LLC is profitable").

80. This approach assumes all income from an LLC that is not excluded under section 1402(a) of the Internal Revenue Code is subject to SECA tax, consistent with the CBO projections, but some practitioners may take the position that an inactive member of an LLC should be taxed the same as an inactive member of an LLP based on Proposed Treasury Regulations section 1.1402(a)-2(g)–(h), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997), which was never made final. *See* discussion *infra* section III.D.

81. Lest this negative view of LLCs from a payroll tax perspective should inaccurately lead one to believe that LLCs and other tax partnerships are disfavored by the tax code, there are other potentially more important factors that might lead a business arrangement to be structured as a tax partnership, including, but not limited to, the very flexible provisions for special allocations of items of income and loss pursuant to section 704(a) of the Internal Revenue Code that are generally upheld so long as the allocation has substantial economic effect. Treas. Reg. § 1.704-1(b)(2)(i)–(iii) as amended in 2013; *see* LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS 44–74 (West 4th ed. 2011). The ability to do special allocations is one of the reasons LLCs remain the entity of choice among start-up

then earn capital income from investments in corporate entities, regardless of whether those entities are closely held or publicly traded, are not taxed under FICA on any of the income from their capital investments. To the extent that the incidence of both the employee and employer side of the FICA tax is actually borne by the employee,[82] the only difference between the FICA tax base and the SECA tax base is this taxation of capital. Because owners of S corporations are not taxed on such capital, the S corporation regime for determining the SECA tax base most closely approximates the payroll tax base applicable to the general wage-earning population under FICA.

## C. Illustrating the Inconsistencies

If a picture is worth a thousand words, then a simple example may be helpful to illustrate how owners of different tax entities and non-owners are treated so differently. In this example, there are two owners of a business: "A" the affluent and inactive investor and "B" who works full time in the business. The business has no income from the types of capital described in § 1402(a), meaning that all capital income is associated with the company's goodwill (such as business processes, branding, client lists, know-how, etc.). Comparing this same business based on whether it is taxed as an LLC, an LLP, or an S corporation illustrates the significant variance in the SECA tax liability of owners A and B.

### *1. SECA Tax Base for S Corporation, LLC, and LLP Modeled*

In the first two examples, the business has $1.2M in revenues and $900,000 of expenses for a gross profit margin, excluding any compensation to B, of $300,000, which is split 50–50 both for tax purposes and for purposes of distributions between the two owners.[83] We will assume that an employee in the same industry with B's skill and experience makes a salary of $75,000:

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companies notwithstanding the payroll tax advantages of S corporations. *See, e.g.*, Jerald David August, *Benefits and Burdens of Subchapter S in a Check-The-Box World*, 4 FLA. TAX REV. 287, 298–99 (1999) (noting that the one-class-of-stock requirement for S corporations precludes creating distribution and liquidation preferences, as well as special allocations of tax items).

82. *See* Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top of One Percent*, 56 SMU L. REV. 99, 104 ("[E]conomists generally agree that the economic incidence of both the employer and employee portions of the payroll taxes is borne by the employee.").

83. The 50–50 allocation could vary by agreement of the parties under the special allocation rules for entities taxed as partnerships pursuant to section 704(a) of the Internal Revenue Code so long as the allocation has substantial economic effect. *See* sources cited *supra* note 81.

| Table 1: Comparison of SECA Tax Liability Among Flow-Through Entities | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | LLC | | | LLP | | | S Corporation | | |
| Owner | A | B | Total | A | B | Total | A | B | Total |
| Income | $150,000 | $150,000 | $300,000 | $150,000 | $150,000 | $300,000 | $150,000 | $150,000 | $300,000 |
| Dividends * | $ - | $ - | $ - | $150,000 | $ - | $150,000 | $150,000 | $ 75,000 | $225,000 |
| SECA Base | $113,700 | $113,700 | $227,400 | $ - | $113,700 | $113,700 | $ - | $ 75,000 | $ 75,000 |
| 12.4% Rate | 12.4% | 12.4% | $ 0 | 12.4% | 12.4% | $ 0 | 12.4% | 12.4% | $ 0 |
| SECA Tax | $ 14,099 | $ 14,099 | $ 28,198 | $ - | $ 14,099 | $ 14,099 | $ - | $ 9,300 | $ 9,300 |
| HI Base | $150,000 | $150,000 | $300,000 | $ - | $150,000 | $150,000 | $ - | $ 75,000 | $ 75,000 |
| HI 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% |
| HI Tax | $ 4,350 | $ 4,350 | $ 8,700 | $ - | $ 4,350 | $ 4,350 | $ - | $ 2,175 | $ 2,175 |
| **Total SECA Tax** | **$ 18,449** | **$ 18,449** | **$ 36,898** | **$ -** | **$ 18,449** | **$ 18,449** | **$ -** | **$ 11,475** | **$ 11,475** |
| * The example is focused solely on the payroll tax consequences and, as such, it drastically oversimplifies the "Dividends" line item, which in reality would represent any number of things from a distributive share of profits of a tax partnership, to dividends from an S corporation, or dividends from a C corporation. Each of these items would have drastically different consequences for purposes of income taxes, but the payroll tax bases are generally unconcerned with such distinctions. | | | | | | | | | |

Based solely on the payroll tax effects, A would clearly disfavor the LLC form where A's payroll tax liability would be $18,449, and B would have a strong preference for being organized as an S corporation where B's SECA tax liability would be just $11,475. Thus, the self-employment tax effects would favor organization as an S corporation for this business.[84] These decisions are certainly not made in isolation, and so other critical factors, including the different income tax treatment of other items and concerns over limitations on liability, would also play an important role. For instance, LLPs are generally disfavored because of personal liability exposure to general partners. Depending on the form of the business activities, if the two most important factors are limiting payroll tax liability and personal liability, then the S corporation represents the best of both worlds for both owners in this simple case.

84. A recent study indicated that shareholders of S corporations face the highest effective tax rates of all entity types, but as the study points out, this result was driven by an increase in the highest marginal tax rates for individuals and the fact that S corporation shareholders both reported the most income from other sources and reported business income levels that were much higher than the income reported by other pass-through entities. *See* QUANTRIA STRATEGIES, LLC, ENTITY CHOICE AND EFFECTIVE TAX RATES 20-21 (2013), *available at* http://waysandmeans.house.gov/uploadedfiles/quantria_study_etr_8613_final_pm_embargoed.pdf. While the study has been misquoted to support the assertion that S corporations are disfavored under the tax law because of a higher average effective tax rate, the higher rates paid by S corporation shareholders are really an indication that wealthier taxpayers tend to prefer this entity type, particularly where income from the business represents only a portion of a taxpayer's total income, which is wholly consistent with the findings in this example.

### 2. *Comparing Treatment of Owners and Employees Under SECA and FICA*

Next we consider the distinction between owners and non-owners—non-owners meaning individuals who own interests in companies other than the company that pays their wages. Assuming that B, the employee, earns $75,000 *before* taking into account both the employer and employee portions of the FICA tax in wages[85] and $75,000 in dividends from capital investments in publicly traded companies.[86] For purposes of the non-owners, A will be an investor who makes $150,000 in dividends from capital investment in this same publicly traded company.

| Table 2: Comparison of SECA & FICA Tax Liability Between Flow-Throughs & Non-Owner Sources | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | LLC | LLP | S Corporation | | | Wages & Publicly Traded Capital | | |
| Owner | Total | Total | A | B | Total | A | B | Total |
| Income Allocation | $300,000 | $300,000 | $150,000 | $150,000 | $300,000 | $112,500 | $187,500 | $300,000 |
| Dividends | $ - | $150,000 | $150,000 | $ 75,000 | $225,000 | $125,000 | $ 75,000 | $200,000 |
| SECA Base | $227,400 | $113,700 | $ - | $ 75,000 | $ 75,000 | $ - | $ 75,000 | $ 75,000 |
| Tax Rate 12.4% | 12.4% | 12.4% | 12.4% | 12.4% | 12.4% | 12.4% | 12.4% | 12.4% |
| Tax | $ 28,198 | $ 14,099 | $ - | $ 9,300 | $ 9,300 | $ - | $ 9,300 | $ 9,300 |
| HI Base | $300,000 | $150,000 | $ - | $ 75,000 | $ 75,000 | $ - | $ 75,000 | $ 75,000 |
| HI 3.8% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% |
| HI Tax | $ 8,700 | $ 4,350 | $ - | $ 2,175 | $ 2,175 | $ - | $ 2,175 | $ 2,175 |
| **Total SECA Tax** | $ 36,898 | $ 18,449 | $ - | $ 11,475 | $ 11,475 | $ - | $ 11,475 | $ 11,475 |
| * Amounts are based on the totals for both taxpayers A and B as reflected in Table 1. | | | | | | | | |

Based on this hypothetical, it is clear that the payroll tax paid under the S corporation form using the reasonable compensation standard is the closest approximation to the FICA tax that would otherwise apply in a non-owner context. In fact, the amount paid is exactly the same so long as the allocable earnings of the business exceed the reasonable compensation or value of the owner–employee's services.

85. Comparing SECA and FICA is always somewhat problematic because of the employer portion of the FICA tax, but, for purposes of simplicity and without engaging in the incidence debate, the model implies that the economic incidence of both portions of the tax is borne by the employee.

86. There are several obvious limitations to this model in practice, but it has been deliberately oversimplified to show the effect across different entities holding all things equal. For instance, in order for the assumptions about the effect of the employee's wages on the investor's income allocation to hold true, the publicly traded corporation would have to pay an equivalent amount of wages to all of its employees on a per-revenue basis as the smaller corporation, ignoring economies of scale.

So members of LLCs are shouldering a disproportionately high burden of both the SECA tax load and the overall payroll tax load through the taxation of their capital investment that similarly situated owners of S corporations and wage earners with other capital investments are not subject to. It is odd that the payroll tax system has been crafted in a manner that creates a perverse incentive to keep wage earnings and income from capital separate. It is difficult to justify this disparate treatment, which is almost certainly an unintended consequence.

### 3. *The Benefits of Ownership Under SECA Tax Where the Value of Services Provided Exceeds the Income from the Entity*

Notwithstanding the above arguments, which apply to the extent that B earns more income from the business than the value of B's reasonable compensation, this only tells half of the story. If the employee–owner's portion of the income from the business is less than the value of services that the employee–owner provides to the company, then there are actually significant benefits to being an owner as opposed to a similarly situated non-owner. To the extent that the owner's labor income or the value of the services the owner provides to the business exceeds the owner's distributive share of net income from the business, the owner's SECA tax liability is based on that lesser amount rather than the actual value of the services provided by the owner. Income that would otherwise be taxed in two separate pieces, one part as positive income from wages and one part as an unrealized capital loss in the form of a reduction in value of the business's goodwill, is combined and netted out. The following chart illustrates this issue:

Table 3: Comparison of SECA Tax Liability Across Various Entities

| | LLC * | | | LLP * | | | S Corporation | | | Wages & Publicly Traded Capital | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | A | B | Total | A | B | Total | A | B | Total | A | B | Total |
| Income Allocation | $25,000 | $25,000 | $50,000 | $25,000 | $25,000 | $50,000 | $25,000 | $25,000 | $50,000 | $(12,500) | $62,500 | $50,000 |
| Gain/Loss | $ - | $ - | $ - | $25,000 | $ - | $25,000 | $25,000 | $ - | $25,000 | $(12,500) | $(12,500) | $(25,000) |
| SECA Base | $25,000 | $25,000 | $50,000 | $ - | $25,000 | $25,000 | $ - | $25,000 | $25,000 | $ - | $75,000 | $75,000 |
| Tax Rate 12.4% | 12.4% | 12.4% | $ 0 | 12.4% | 12.4% | $ 0 | 12.4% | 12.4% | $ 0 | 12.4% | 12.4% | $ 0 |
| Tax | $ 3,100 | $ 3,100 | $ 6,200 | $ - | $ 3,100 | $ 3,100 | $ - | $ 3,100 | $ 3,100 | $ - | $ 9,300 | $ 9,300 |
| HI Base | $25,000 | $25,000 | $50,000 | $ - | $25,000 | $25,000 | $ - | $25,000 | $25,000 | $ - | $75,000 | $75,000 |
| HI 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% | 2.9% |
| HI Tax | $ 725 | $ 725 | $ 1,450 | $ - | $ 725 | $ 725 | $ - | $ 725 | $ 725 | $ - | $ 2,175 | $ 2,175 |
| **Total SECA Tax** | **$ 3,825** | **$ 3,825** | **$ 7,650** | $ - | **$ 3,825** | **$ 3,825** | $ - | **$ 3,825** | **$ 3,825** | $ - | **$11,475** | **$11,475** |

The significantly higher FICA taxes paid by B as a wage-earning employee are the result of B earning $75,000 in wages, notwithstanding the $12,500 in losses from the corporation. This indicates that owner–employees receive a significant SECA tax benefit compared to their wage-earning and separately investing counterparts when faced with negative income from capital that would otherwise be included in the SECA tax base. The CBO estimated that in 2004 this offset resulted in a 56% reduction in the SECA tax base compared to the amount that would be included if the owner–employee's SECA base was determined under the reasonable compensation standard applicable to corporations under the FICA tax regime.[87]

At first glance, this policy seems appropriate as it would create a negative incentive against owning one's own business if the SECA tax base for self-employed individuals were set to the value of the reasonable compensation for services provided to their business without regard to whether the owner-employee had any actual income from the company. This justification falls flat, however, to the extent that the business generates income well in excess of the value of the services the employee–owner provides to the company in later years. The employee–owner's efforts in prior years when the company has insufficient income to include the value of these services in the SECA tax base may result in significant income in later years, but the reduction in the SECA tax base from the prior years is never recaptured.

### D. The Tax on Net Investment Income Enters the Fray, Adding Another Layer of Complexity on Top of an Already Incoherent Payroll Tax Regime

Pursuant to section 1411 of the Internal Reveue Code, starting in 2013 there is a 3.8% tax imposed on "net investment income" in excess of the applicable modified adjusted gross income amount, which is $250,000 for joint filers, $125,000 for married filing separately filers, and $200,000 for most other taxpayers.[88] There is a parallel tax applicable to wage income under both FICA and SECA that is meant to ensure that all income in excess of these same thresholds is subject to a 3.8% tax, regardless of whether the income is from investment or wages.[89] The definition of net investment income is quite similar, presumably intentionally, to the types of income excluded from SECA tax under section 1401.[90] Similar to section 1401, the definition of net investment income is an incomplete list of capital income items that

87. CONG. BUDGET OFFICE, *supra* note 17, at 10–11. *But see* Glass Blocks Unlimited v. Comm'r, 106 T.C.M. (CCH) 657 (2013) (holding that distributions to the taxpayer were wages subject to FICA and not a repayment of loans even though such wages exceeded the taxable income attributable to the taxpayer from his wholly owned S corporation).

88. *See* I.R.C. § 1411(b) (2012).

89. *See* I.R.C. §§ 3101(b)(2) & 1401(b)(2)(A) (2012).

90. *Compare* I.R.C. § 1411(c), *with* I.R.C. § 1401.

fails to include income from capital invested in tangible and intangible assets.[91] Not surprisingly, practitioners have already expressed confusion as to how the new law should be interpreted and what types of income this law applies to, particularly in the flow-through entity context,[92] and the Department of the Treasury has issued proposed regulations to provide guidance in interpreting the new law.[93]

The net investment income tax was not meant to cover income that is subject to self-employment tax, and in fact, there is a specific exclusion for any income item taxed under the self-employment regime ensuring that such income is not subject to both the 3.8% net investment income tax and the 3.8% SECA or FICA tax.[94] However, the net investment income tax does not capture all income that is excluded from SECA tax. One critical and glaring omission is that net investment income excludes operating income from nonpassive business activities.[95] Whether such income is derived from a nonpassive activity is determined at the taxpayer level based on the general material participation principles of the passive loss limitation rules under section 469.[96] Combining this significant net investment income tax gap with the SECA tax regime applicable to S corporations means that nonpassive business income allocable to shareholders of S corporations in excess of the value of their reasonable compensation would be subject to neither SECA taxes nor the net investment income tax.[97] Applying the passive loss limitation rules in this manner does allow the net in-

91. *See* I.R.C. § 1411(c).
92. *See* Donald B. Susswein, McGladry LLP, Statement at Public Hearing on Proposed Regulations to Implement the Net Investment Income Tax Under the Internal Revenue Code Section 1411 (Apr. 2, 2013) (noting that although "[a]t first blush, the idea of extending the existing health insurance tax and personal service income . . . to investment income seems quite straightforward, . . . [i]n practice, however, it is a quite difficult matter to get it working correctly"); Kim Dixon, *U.S. IRS Weighs Changes to Obama Healthcare Investment Tax Rules*, REUTERS (Apr. 2, 2013, 6:05 EDT), http://www.reuters.com/article/2013/04/02/usa-tax-healthcare-investment-idUSL2N0CP1I020130402.
93. *See* Prop. Treas. Reg. §§ 1.1411-1 to -10, 77 Fed. Reg. 72612, 72634–52 (Dec. 5, 2012).
94. *See* I.R.C. § 1411(c)(6).
95. *See* I.R.C. § 1411(c)(1)(A)(ii) & (c)(2)(A) (specifically including gross income from a trade or business only to the extent that it is derived from passive activities).
96. *See* Treas. Reg. § 1.1411-5(b) (2013).
97. *See* Steven B. Gorin, Lisa M. Rico, & Amber K. Quintal, *Get Ready for the 3.8% Tax on Net Investment Income*, 27 PROB. & PROP., July–Aug. 2013, at 30 (noting that wealthy individuals who may have previously preferred passive income to offset passive losses may "benefit from transforming passive income into nonpassive income by grouping activities together to satisfy the material participation tests, as long as this can be done without dis-allowing passive losses or subjecting the income to self-employment tax."); PRICEWATERHOUSECOOPERS, PLANNING FOR THE NET INVESTMENT INCOME TAX, ALSO KNOWN AS THE MEDICARE CONTRIBUTION TAX 3 (2012), *available at* http://www.pwc.com/us/en/private-company-services/publications/assets/pwc-pfs-planning-update-net-investment-tax.pdf.

vestment income tax to capture certain income from limited partners and inactive members of LLCs that may generally otherwise be excluded from the SECA tax base, but the omission of nonpassive income from the net investment income tax base exacerbates the disparity between owners of S corporations and all other similarly situated taxpayers without any substantive policy justification.

Practitioners have also expressed concerns over whether income from trusts and certain rental activities should be included in the net investment income tax base, and so there appears to be some confusion as to what may be legally excluded.[98] There is merit to such confusion. Under section 1411(a)(2) of the Internal Revenue Code, the 3.8% tax is imposed on the lesser of the undistributed net investment income of an estate or trust or the adjusted gross income of the estate or trust that is taxed at the highest tax bracket, noting that the highest tax bracket applicable to trusts kicks in at just $11,950 in income in 2013.[99] But the determination of whether income from an estate or trust is nonpassive is an unsettled area of the law that is fraught with peril.[100] Section 469 was not written in contemplation of the activities of trusts and estates and, further, the regulation section reserved for specifically applying the passive activity rules in the context of trusts and estates has not yet been written.[101] So the further application of section 469 to determining the net investment income tax for trusts presents additional unnecessary and unwelcomed complexity. Additionally, as discussed later,[102] using the distinction between passive and active income derived from the passive loss limitation rules fails as a proxy for distinguishing between wages and capital income.

## V. STANDARDIZING THE PAYROLL TAX TREATMENT FOR ALL TAXPAYERS

As a preliminary matter, before discussing the different approaches for standardizing the SECA tax base across all entities, it is worth considering whether such a result is desirable. The lack of consistency between the SECA tax bases for different tax entities is not necessarily a problem as long as there is a legitimate reason for the distinctions, but as discussed above,[103] the variance in the SECA tax bases between different flow-through entities results from either an

98. Dixon, *supra* note 92.
99. See I.R.C. § 1(e) (2012); Rev. Proc. 2013-15, 2013-5 I.R.B. Table 5.
100. *Compare* Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003) (deciding material participation based on both the activities of the trustee and the individuals conducting the business of the trust), *with* I.R.S. Tech. Adv. Mem. 200733023 (Aug. 17, 2007) (deciding material participation based only on the activities of the fiduciary).
101. *See* Treas. Reg. § 1.469-8 (1992).
102. *See* discussion *infra* section V.B.
103. *See* discussion *supra* section III.B.

accident of history or policies that are no longer applicable or relevant. As such, these inconsistencies create additional administration and complexity for the taxpayers, as well as tax-planning opportunities, without any corresponding benefit. Commentators uniformly agree the current regime stands in need of repair and have proposed various solutions.[104] Indeed, while this author proposes a very specific solution to this variance in the SECA tax base across flow-through entities, any movement toward standardization using any of these methods would likely be an improvement over the current regime in terms of the ease of administration and clarity.

### A. Why a Standardized Payroll Tax System May Be Politically Feasible

The House Ways and Means Committee is considering options for reforming the income tax of small businesses and flow-through entities and has circulated a discussion draft of some of the currently proposed provisions.[105] The discussion draft contains two options with the first option consisting of a number of changes within the current S corporation/partnership dichotomy and the second a far more drastic option that essentially uproots Subchapter K and Subchapter S and supplements these sections with a unified Subchapter K covering all flow-through entities.[106] The first option consists of a series of comparably minor changes to Subchapter K and Subchapter S consistent with several proposed changes previously advanced by Congress and scholars alike[107] that would represent a more modest, albeit significant, move toward uniformity of income taxation for flow-through en-

104. *See, e.g.*, CONG. BUDGET OFFICE, *supra* note 17; SECTION OF TAXATION, AM. BAR ASS'N, TAX RULES GOVERNING SELF-EMPLOYMENT INCOME OF LIMITED LIABILITY COMPANIES AND PARTNERSHIPS (2002), *available at* www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2002/020529c.authcheckdam.pdf; Altman, *supra* note 25, at 167; Dilley *supra* note 33, at 376–77; Thomas E. Fritz, *Flow-through Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?*, 17 Va. Tax Rev. 811, 870–71 (1998); Michael E. Mares, Am. Inst. of Certified Pub. Accountants, *Legislative Proposal Regarding Tax on Self-Employment Income Under Section 1402 of the Internal Revenue Code of 1986*, TAX NOTES TODAY, Feb. 27, 1998, *available at* LEXIS, 98 TNT 39-34.

105. *See generally* HOUSE COMM. ON WAYS AND MEANS, 113TH CONG., WAYS AND MEANS DISCUSSION DRAFT TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO PROVIDE FOR COMPREHENSIVE INCOME TAX REFORM (2013).

106. *See* Willard B. Taylor, *Subchapter S Out the Window? What's Going On?*, 139 TAX NOTES 1051 (2013).

107. *Compare id.*, *with* S Corporation Modernization Act of 2013, H.R. 892, 113th Cong. (2013), S Corporation Modernization Act of 2011, H.R. 1478, 112th Cong. (2011), SECTION OF TAXATION, AM. BAR ASS'N, OPTIONS FOR TAX REFORM IN SUBCHAPTER S OF THE INTERNAL REVENUE CODE 1 (2013), STAFF OF JOIN COMM. ON TAXATION, JCS-6-97, REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES (1997), *and* William B. Brannan, *The Subchapter K Reform Act of 1997*, 75 TAX NOTES 121 (1997).

tities.[108] Option two would throw out Subchapter S entirely and combine all flow-through entities under a standardized subchapter K.[109]

While these two options vary drastically in terms of the scope of the proposed changes to current law, either option would represent a significant step toward standardizing the income taxation of flow-through entities. Neither option currently takes any position as to which standard would be applied to determine the SECA tax base.[110] But even if the far less ambitious first option were adopted into law, it would demonstrate a clear congressional intent to simplify the tax code as to flow-through entities. Moreover, the passage of that law would suggest that such a simplification is a politically feasible priority. An accompanying simplification and unification of the SECA tax regime would be consistent with congressional intent to simplify the tax code as to flow-through entities. It would be far more difficult to imagine the adoption of the second option without a corresponding provision unifying the SECA tax[111] both based on the logic that Congress would certainly not want to unify the income tax and retain a completely decoupled SECA tax regime and because, as a practical matter, many of the current SECA tax provisions rely on the underlying Code sections that would be amended or deleted if such an option were adopted. So there clearly appears to be some degree of motivation on the hill to both simplify and unify the taxation of flow-through entities from both sides of the political aisle and, based on that backdrop, the focus now turns to which proposal might most effectively accomplish these goals.

### B. The Three Standardizing Approaches Previously Proposed by the Congressional Budget Office

The CBO analyzed three different approaches for defining the SECA tax base as an alternative to the current model that would either clarify the proper tax base across entities or include less capital income.[112] These models include: (i) the material participation standard, (ii) the reasonable compensation standard, and (iii) the safe harbor calculation of capital income.[113] The material participation standard would standardize the SECA tax treatment across different types of partnerships while the reasonable compensation standard and the safe harbor calculation of capital income would standardize

108. *See* Taylor*, supra* note 106.
109. *See* HOUSE COMM. ON WAYS AND MEANS, *supra* note 105.
110. *Id.*
111. Although it is equally difficult to imagine any such sweeping tax legislation passing in the first place given the current climate in Washington, D.C. .
112. CONG. BUDGET OFFICE, *supra* note 17, at 18.
113. *Id.* at 18–23.

the SECA treatment across all types of entities by eliminating capital from the SECA tax base.[114]

The material participation standard takes a page out of the passive loss limitation rules—where material participation is generally based on whether the owner engages in the operation of the business for more than 500 hours (lower thresholds apply if the owner is the primary or only participant in the company)[115]—and then imposes SECA tax on all income of material participants, presumably subject to the current exclusions of passive items.[116] This would impose SECA tax on the income of limited partners in LLPs that are currently exempt from SECA tax liability if they are active participants under the passive loss limitation rules. On the other hand, the income of participating members of an LLC that fall short of material participation would no longer be subject to SECA tax.[117]

The material participation standards are an odd fit for the SECA tax base, as they were never intended to approximate wages. The passive loss limitation rules were adopted to prevent taxpayers from using non-economic tax shelter losses to offset their positive sources of income, which constitute the major part of the federal income tax base.[118] These rules use an inefficient and complicated, yet highly effective, standard to decipher between economic and non-economic losses necessitated by the significant abusive tax shelters, which need to be quelled in a sweeping practical manner.[119] There can be little argument that certain legitimate economic losses cannot be taken under these rules. Likewise, applying the rules as a proxy for wages would eliminate items that clearly are wages from the SECA tax base and would continue to include in the base other income items that clearly are not. Additionally, this method is completely inconsistent with FICA taxes, which assess a tax on the first dollar earned and the first hour worked, without regard to the number of hours worked by the employee.[120] For these reasons, a material participation standard is a poor metric for calculating wages for the SECA tax base.

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114. *Id.*
115. This is an intentionally gross oversimplification of the passive loss limitation rules under I.R.C. section 469. For a far more complete description of the passive loss limitation rules, see the relevant section 469 regulations.
116. Cong. Budget Office, *supra* note 17, at 19.
117. This is a position that undoubtedly is already being adopted by some such LLC member taxpayers based on the Temporary Regulation § 1.1402(a)-2, even though that regulation has never been made final.
118. Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. Cal. L. Rev. 1, 3 (1988).
119. The "practical" nature of the passive loss rules applies to the taxing authority, not the taxpayer, because the sheer complexity of the rules for taxpayers seeking to be excepted from the general rules ensures that most taxpayers simply will not bother attempting to take such losses.
120. *See supra* text accompanying notes 4–6.

The next approach discussed by the CBO is the reasonable-compensation standard.[121] This standard already applies to S corporations and C corporations, which are required to report the reasonable compensation earned by shareholders,[122] and so this approach would merely extend the currently existing law for corporations to tax partnerships. The concept of reasonable compensation is well established under section 162 of the Internal Revenue Code and the supporting regulations.[123] The test for reasonable compensation is generally an objective test of simply assessing the value of the services provided under the circumstances. "It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances."[124] Inasmuch as the policy for payroll taxes is to assess a tax on wages and provide a direct benefit to wage earners, using the reasonable compensation standard across all entity types is clearly the most consistent approach to the original policy for the SECA and FICA tax regimes.[125]

While there can be little question that this approach is the closest to the original policy for FICA and SECA taxes, the reasonable compensation approach has been greatly criticized because of practical concerns over its administration.[126] The concept of determining reasonable compensation originated with Subchapter C corporations, where the IRS sought to prevent corporate shareholder-employees in closely held corporations from avoiding double taxation by paying themselves wages in excess of their reasonable compensation. This was a problem because amounts that really represented a return on capital in the form of corporate profits that would otherwise be subject to double taxation[127] if paid in the form of wages to an employee–shareholder could be deducted at the corporate level[128] and

121. Cong. Budget Office, *supra* note 17, at 21.
122. *Id.*
123. I.R.C. § 162(a)(1) (2012).
124. Treas. Reg. § 1.162-7(b)(3) (1960).
125. This is consistent with the exclusionary approach proposed by Thomas Fritz where all income from flow-through entities is deemed income from capital except for the income related to services performed. *See* Fritz, *supra* note 104 (asserting that the reasonable compensation approach "is the most logical and direct means of identifying and valuing the specific income" for a SECA tax base and that the legitimate potential administrative complexities "should be managed rather than regarded as absolute obstacles to implementing an approach that otherwise is proper").
126. Robert R. Keatinge, Compensation Issues in LLCs and Other Pass-Through Entities 323 n.372 (2012).
127. Meaning these amounts would be taxed at the corporate level and then taxed again as a dividend at the shareholder level.
128. A business may take an ordinary and necessary business expense deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." *See* I.R.C. § 162(a)(1).

taxed only once at the shareholder level as compensation.[129] Thus, the standard was developed initially in a manner that only sought to prevent wages from being overreported. Courts apply a multifactor test to determine whether the compensation is reasonable including:

> the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.[130]

So the determination is heavily factual and, given the number of factors that affect this determination, it is particularly difficult to administer. Additionally, the standard is not meant to determine the actual value of the services provided, but rather, is meant to determine the outside fringe where a reasonable amount of compensation becomes unreasonable with the burden of proof on the taxpayer.[131]

When the standard was turned on its head in the application of determining whether wages taken by a Subchapter S corporation shareholder were unreasonably *low* for purposes of determining SECA taxes, it is not surprising that the results have been less than ideal.[132] The tax strategy has been referred to, somewhat unfairly, as the John Edwards Tax Shelter, based on former presidential and vice presidential candidate John Edwards's use of an S corporation to exclude millions of dollars of income derived from his law practice from payroll taxes in the 1990s and, more recently, the Gingrich Tax Strategy, based on a similar use and result for Newt Gingrich's consulting firm.[133]

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129. John C. Ramirez, *Best Practices: Reasonable Compensation Analysis for C Corporations and S Corporations*, INSIGHTS, Spring 2012, at 46–47, *available at* http://www.willamette.com/insights_journal/12/spring_2012_8.pdf.
130. Charles Schneider & Co. v. Comm'r., 500 F.2d 148, 152 (8th Cir. 1974) (quoting Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949)).
131. B.B. Rider Corp. v. Comm'r., 725 F.2d 945, 952 (3d Cir. 1984).
132. Spicer Accounting, Inc. v. United States, 918 F.2d 90, 93 (9th Cir. 1990) (reassigning income taken as a dividend as wages under the reasonable compensation standard); Radtke v. United States, 895 F.2d 1196, 1197 (7th Cir. 1990) (re-characterizing dividends as wages); Scott E. Vincent, *8th Circuit Finds Accounting S Corporation Paid Unreasonably Low Wages*, 68 J. MO. B. 114, 114–15 (2012) (noting that the IRS may impose employment taxes on the reclassified dividend payments using the minimum reasonable compensation standard); Sean McAlary Ltd. v. Comm'r, T.C. Summ. Op. 2013-62 (Aug. 12, 2013) (finding that only $83,200 of more than $200,000 in income was appropriately deemed wages, which substantially exceeded the $24,000 the taxpayer originally claimed).
133. *See* Paul Sullivan, *The Advantages and Risks of Gingrich's Tax Strategy*, N.Y. TIMES, Feb. 3, 2012, http://www.nytimes.com/2012/02/04/your-money/advantages-and-risks-of-gingrichs-s-corporation.html?pagewanted=all&_r=0.

In *David E. Watson, P.C. v. United States*, a partner in an accounting firm held a 25% interest in his wholly owned S corporation.[134] The S corporation received distributions in excess of $200,000 each year from the accounting firm, but the accountant took a mere $24,000 salary from the S corporation and deemed the remainder to be nonsalary distributions.[135] The court, based on the expert testimony of the IRS, determined that Mr. Watson's reasonable compensation under the circumstances was $91,044.[136] This was a pyrrhic victory for the IRS given that the case required an expert's testimony as well as an appeal to the Eighth Circuit in order to attain a judgment of just more than $10,000 per year[137] before penalties and interest and the resulting increase in payroll taxes will have the result of increasing Mr. Watson's social security benefits upon retirement.

Additionally, Mr. Watson was still successful in excluding more than half of his income from a professional services company, one in which he was a partner, that may have otherwise been included in his SECA base by assigning his interest in the accounting firm to his wholly owned S corporation and applying the more favorable S corporation SECA tax rules. If the same standard were applied to S corporations as to any other entity, then this maneuver would not have reduced Mr. Watson's tax liability.

*Watson* demonstrates that, even though the reasonable compensation standard is clearly the best standard in light of the original policy for payroll taxes and social security, the standard is in need of further guidance from both Congress and the IRS if it is to be the principal vehicle for determining a taxpayer's SECA tax liability. A rule that requires expert testimony when so little tax is in controversy is not administrable, and safe harbor rules providing more specific guidance on the amounts of reasonable compensation taxpayers should claim would be a welcomed addition to the regulatory framework.[138] Indeed, "shareholder/employees of S corporations have an incentive to treat corporate payments to shareholders as something other than compensation for services rendered" in order to minimize payroll

134. 757 F. Supp. 2d 877 (S.D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012).

135. *Watson,* 668 F.3d at 1018.

136. *Id.*

137. The IRS increased Mr. Watson's SECA tax base by $67,044 from $24,000 to $91,044, which would have resulted in an increased payroll tax liability of $10,258 for each year calculated at 15.3%, resulting in the total liability of $23,431.23 to Mr. Watson, including applicable penalties and interest. *See id.* at 1013.

138. Fritz, *supra* note 104 (supporting the reasonable compensation approach for determining the SECA tax base but asserting that Congress should, in the legislative history, clearly establish a preference for "the facts-and-circumstances approach to [defining reasonable compensation], with the greatest emphasis to be given to factors that focus directly on measuring the value of services rendered").

taxes,[139] so it is evident the reasonable compensation standard provides far more opportunities for abuse than the more formulaic LLC and LLP standards. In summary, while the reasonable compensation standard most closely approximates the original policy for determining the proper FICA and SECA tax bases, it stands in need of repair before it can be reliably applied across all flow-through entities to determine the SECA tax base.

The next approach addressed by the CBO is the safe harbor calculation of capital income approach proposed by the American Institute of Certified Public Accountants in 1997 for partners providing more than 100 hours of services to the company.[140] This is basically the opposite approach to the reasonable compensation standard as it seeks to determine what percentage of income is derived from capital and considers the remaining income to be wages.[141] However, since it is difficult to determine the income derived from capital, the approach uses a safe harbor by summing up the total capital investment and applying a rate of return equal to 150% of the maximum applicable federal rate.[142] This approach deliberately favors purchased intangible assets over self-made intangible assets like goodwill, as income from a self-made intangible asset would be considered wages.

Outside this somewhat arbitrary safe harbor, it may be difficult to determine the income from capital. In this context, a preliminary question should be whether it is easier to determine the income derived from a capital investment as opposed to the value of services provided. In theory, either approach should provide the same result, but in practice, it is generally much easier to determine the value of services provided because there is direct evidence in the form of non-owner employees providing similar services, both within and without the company, which can be used as a metric for determining the value of the services provided by the owner–employee. The safe harbor calculation of capital income method is inconsistent with the policy behind the FICA and SECA tax, as it would inappropriately tax self-made capital as wages while purchased capital would be entitled to the benefits of the safe harbor and, outside the safe harbor, the administration of this approach is more difficult than the reasonable com-

139. Herbert v. Comm'r, T.C. Summ. Op. 2012-124, 3 (Dec. 26, 2012) (*nonprecedential* pursuant to I.R.C. § 7463(b) (2012)) (upholding IRS's increased determination of wage amount based on the reasonable compensation standard).

140. The American Institute of Certified Public Accountants (AICPA) approach actually doubled down on the participation standards by including only guaranteed payments for partners contributing less than 100 hours of services but including guaranteed payments and the partners' proportional share of business income less an amount representing capital income based on the safe harbor calculation of capital income. Mares, *supra* note 104.

141. CONG. BUDGET OFFICE, *supra* note 17, at 23.

142. *Id.*

pensation approach. The safe harbor calculation of capital income approach should therefore not be used to determine the SECA tax base. However, the concept of a safe harbor could be effectively implemented into the reasonable compensation approach to ease the administrative burden of determining the SECA tax base.

The tax section of the American Bar Association (ABA) proposed a hybrid approach in 2002 that would "give partners the choice of excluding from the SECA tax base either their income in excess of reasonable compensation or the safe-harbor amount of capital income described by the [American Institute of Certified Public Accountants (AICPA)]."[143] This hybrid approach would entail the same pros and cons as the other approaches it replicates, but it would be very favorable to taxpayers because it would allow taxpayers to elect whichever approach minimizes or maximizes their SECA tax base, depending on whether they were seeking to reduce payroll tax or increase participation in social security. While favorable to taxpayers, the ABA proposal should not be implemented, as it does little to simplify an already overly complicated area of the tax law and is inconsistent with the underlying policy for FICA and SECA for the same reasons as the safe harbor calculation of capital income approach, which the ABA proposal partially implements.

### C. Another Approach for Standardization Is to Apply the SECA Tax Base for Tax Partnerships to Limited Partners in LLPs and Shareholders of S Corporations, but This Approach Is Also Inconsistent with the Policy for Payroll Taxes

One alternative for normalizing the SECA tax base would be to apply the law for LLCs to both LLPs and S corporations. Thus far, it has been taken for granted that the definition of capital income is a simple one, namely, a return on capital investment. But capital income might be viewed as really constituting three different elements: the real risk-free rate of return, the risk premium, and the infra-marginal return.[144] In most cases, capital income consists of the first two elements, but in limited circumstances, it represents the infra-marginal return,[145] which is a return on "ideas, managerial skill, or market power" and represents "a return to a combination of labor, that is, a

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143. *Id.* at 34; *see also* SECTION OF TAXATION, AM. BAR ASS'N, TAX RULES GOVERNING SELF-EMPLOYMENT INCOME OF LIMITED LIABILITY COMPANIES AND PARTNERSHIPS (2002), *available at* www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2002/020529c.authcheckdam.pdf (listing the recommended changes contained in the 2002 proposal and explaining the principles underlying those changes).

144. Noël B. Cunningham, *The Taxation of Capital Income and the Choice of Tax Base*, 52 TAX L. REV. 17, 23 (1996).

145. *Id.*

person's ideas or skills, and capital."[146] The concept of the infra-marginal return is interesting when used to analyze the SECA tax base because it represents returns on capital that look a whole lot more like wages than the risk-free rate of return and the risk premium. Indeed, this mixing of capital and labor, which is particularly problematic where the company is creating its own intangible property, is part of why the reasonable compensation standard is so difficult to administer. So there is a legitimate argument that the infra-marginal return on capital should be part of the SECA tax base because taxing this return is consistent with the policy that the FICA tax base should include labor.

While the infra-marginal return analysis provides an important theoretical justification for a more expansive payroll tax base than a mere tax on wages or reasonable compensation, it is not consistent with the SECA tax base for entities taxed as partnerships where the tax on capital is based on taxing tangible and intangible property and, as a practical matter, it may be impossible to administer.[147] However, if the value of the services portion of this return is adequately accounted for through the reasonable compensation standard, then the remaining synergistic value of the "idea" would be appropriately attributable to capital under the reasonable compensation standard. For instance, the infra-marginal returns from publicly traded companies are never included in the FICA tax base, so deeming these returns to be capital in nature, except to the extent of the services portion, would be consistent with the FICA tax portion of such returns. Thus, while using the infra-marginal return might be a legitimate justification for expanding the SECA and FICA tax bases beyond the mere taxation of wages, doing so would require changes to the payroll tax base for all taxpayers if such a method were to be consistent across the board. Additionally, it should be noted that simply expanding the SECA base currently applicable to tax partnerships to both S corporations and LLPs also does not accomplish this goal.

Applying the LLC standard to other flow-through entities might make sense based on the benefits and burdens analysis. The limitations on social security participation were enacted because participation in social security was viewed as a significant benefit that should be limited to wage earners rather than merely as a tax burden.[148] However, because the average social security tax now far outweighs the anticipated benefit, the policy arguably no longer supports limiting participation to wages because the direct burdens already exceed the direct benefits—deteriorating the distinction between the social security tax and the income tax. Under this analysis, applying the

146. *Id.*
147. *Id.*
148. *See supra* notes 39–44 and accompanying text.

law for tax partnerships to all flow-through entities would be appropriate, and doing so would, without question, raise significant tax revenues. But taking this approach would also represent a further abandonment of the original purpose of the payroll tax program and would disfavor owner–employees by significantly increasing the gap between the FICA and SECA tax bases. This would be a deliberate move in the direction of the policy for an income tax. Therefore, a more appropriate solution would be to restore the social security program to its original intended purpose as a tax and benefit for wage earners rather than expanding the tax base—and the related benefits—to new sources of capital income.

### D. The IRS's Noble but Futile Attempt to Standardize the SECA Tax Base Between LLCs and LLPs

Interestingly, the IRS attempted to implement regulations that would have granted the same tax treatment enjoyed by limited partners in LLPs to certain inactive members of LLCs, but Congress prevented the IRS from making the proposed regulations final. In 1997, the IRS issued proposed Treasury regulation section 1.1402(a)-2, which exempted inactive members of an LLC from SECA on distributions,[149] thereby closing the gap as to SECA taxes between LLCs and LLPs for certain members. This was actually a revision to the IRS's 1994 attempt,[150] which treated an LLC member as a limited partner if the member did not have authority to participate in management and the member could have qualified as a limited partner under the law of the relevant jurisdiction.[151]

The 1997 proposed regulations treated an LLC member the same way as a limited partner in an LLP, meaning the member's income would not be included in the SECA tax base, unless:

(i) the member had personal liability for LLC debts, (ii) the member had authority to contractually bind the LLC under state law, (iii) the member participated in management for more than 500 hours during the taxable year, or (iv) substantially all of the activities of the LLC involve certain professional services and the member provided professional services on behalf of the LLC.[152] Such professional services include services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[153] While this standard is similar to the standard applicable to limited partners, this would have expanded the tax base as to limited partners contributing more than 500 hours of labor, but given the limitations on limited partners en-

149. Prop. Treas. Reg. § 1.1402(a)-2(g)–(h), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).
150. Prop. Treas. Reg. § 1.1402(a)-18(c)(3), 59 Fed. Reg. 67253 (Dec. 29, 1994).
151. *See* Koski, *supra* note 76, at 88.
152. Prop. Treas. Reg. § 1.1402(a)-2(g)–(h), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).
153. *Id.* § 1.1402(a)-2(h)(6)(iii).

gaging the business, such contributions of labor would typically be the exception to the rule.

Since limited partners are taxed in a similar manner to shareholders in S corporations, this proposed regulation would have cured the inequity between partnerships and S corporations as to SECA taxes on dividends and distributions for individuals who were wholly inactive in the business, but this would not have benefited active members in LLCs and LLPs. Also, while the regulation represents a step in the right direction in terms of consistency across different entities, it suffers from the same issues as the CBO proposal because it is tied to an arbitrary distinction derived from the passive loss limitation rules. The IRS appears to want to return to the 1970s policy of excluding passive income as a proxy for capital income even though this is wholly inconsistent with the administration of FICA taxes. Regardless, proposed Treasury regulation section 1.1402(a)-2 was never made final because Congress issued a moratorium preventing the Treasury from making this regulation final as part of the Taxpayer Relief Act of 1997.[154] Following the brief period of the moratorium, the IRS never issued a final regulation, and the law as to inactive members of an LLC remains unclear. Therefore, the counterintuitive and arbitrary differences between the SECA tax burdens of different owners depending on what type of flow-through entity they elect to become (or fail to elect to become) have survived through to the present day.

## VI. UTILIZING A MODIFIED VERSION OF THE REASONABLE COMPENSATION STANDARD TO REMEDY THE INCONSISTENCIES BETWEEN THE BASES FOR SECA TAX, FICA TAX, AND THE NET INVESTMENT INCOME TAX

The reasonable compensation standard is the best standard for determining the proper SECA tax base because (i) it is the most consistent approach to the original intent of FICA and SECA taxes—that they be a tax on wages and not capital—(ii) it provides the most consistent results across the FICA and SECA tax bases, and (iii) it does not include any income from capital. The problems with applying the reasonable compensation standard to all taxpayers are that doing so may significantly reduce the SECA tax base without an equivalent corresponding reduction in the benefits paid out under social security and that it is administratively difficult to implement. In the past this author favored a simpler-is-better approach to drafting legislation

154. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 ("No temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.").

and, consistent with that approach, this Part tackles some ways that the current application of the reasonable compensation standard could be simplified, improved, and universally applied across all flow-through entities.

### A. The SECA Tax Base Should Include Only the Value of Services the Owner–Employee Provides to the Entity

The difficulty in applying the reasonable compensation standard is largely a self-inflicted wound. The IRS has sufficient data based on the huge number of employee–taxpayers that it can easily calculate the value of reasonable compensation for various types of services an employee–owner may provide to a company. Since the value of services paid to employees is generally an arms-length transaction between unrelated parties, this value is the most effective way of determining the appropriate level of reasonable compensation for an owner–employee providing the same services. A safe harbor salary amount could be provided for nearly every type of service by simply publishing in regulations the average salary for such services based on a number of factors including the employee's geographical region, job title, function, qualifications, years of experience, and other determining factors. If the IRS published these safe harbor averages, then employee–owners and the IRS could rely on them without the expense of costly expert witnesses during litigation, and the only issue would be whether the employee–owner's self-reported description of the services he or she provides is accurate and complete. If either the employee–owner or the IRS sought to assert a salary that varied from the applicable safe harbor amount, then the burden would be on the moving party to prove that such amount represents the accurate value of the services provided subject to a rebuttable presumption that the safe harbor is correct.

Additionally, the safe harbor method would allow for an owner–employee that wears several different hats in the business to accept the reasonable compensation for each such job description. For instance, an attorney that leaves a larger firm to work as a sole proprietor would spend significantly more time on many varied activities, such as administrative assistant work, marketing, client development, and billing, as opposed to only providing legal services full time. That same attorney may have previously billed 2,000 hours a year to legal services alone and spent only a negligible amount of time on other activities, but upon going it alone, this attorney may spend 250 hours doing marketing and client development, 250 hours doing billing and accounting, and then the remaining 1,500 hours doing billable work. Applying a reasonable compensation standard to such a sole proprietor attorney on an hourly basis using the different job descriptions and hourly rates would accurately determine the value of all the services the attorney–owner provided throughout the year. Additionally, to the extent that the attorney's marketing efforts, reputation, or business processes allow the attorney to achieve greater than normal returns on legal services provided—or to the extent that the attorney expands and brings in associates and paralegals—these additional returns in excess of the value of the attorney's services would be properly attributable to the attorney's investment in goodwill, regardless of whether that goodwill were purchased or homegrown.[155] While this approach would provide significant opportunities for abuse under the current lack of guidance, the implementation of safe harbors would allow for the efficient and reliable administration of the reasonable compensation standard.

### B. To the Extent the Value of Services Provided By an Owner–Employee Exceeds the Income from the Entity, the Difference Should Be Carried Forward for Up to Three Years and Applied to Other Income of the Owner–Employee to the Extent Such Income Exceeds the Value of Services Provided

Another problem facing the SECA tax base is the fact that start-up companies often generate profits in later years based on services provided in earlier loss years. A taxpayer can thereby avoid SECA taxes by providing services during the loss years and then, upon turning a profit, hire out the services to third parties, thereby avoiding SECA tax obligations altogether. These issues are not unique to this proposal, and such strategies are undoubtedly used under the current regime. The remedy for this would be to simply apply a payroll tax on the value of the services provided by the owner–employee without regard to the profits of the company. The problem with attempts to remedy this issue in this manner is that some businesses simply never turn a profit, and it would be patently unfair to impose a tax burden on a taxpayer if the taxpayer's services were provided to their own business for several years but the taxpayer never actually realized profits equal to the value of such services. Taxpayers in this situation would be hit with the double negative of having realized less income than their services would have otherwise merited and being stuck with a tax burden based on wages that may never be received.

155. This represents a shift in thinking, particularly as to the payroll tax obligations for professionals in professional services firms, which have long been believed to be bereft of returns on goodwill or anything besides compensation for services provided. *See* INTERNAL REVENUE SERV., *supra* note 11, at 14 ("Wages subject to federal employment taxes generally include all pay you give to an employee for services performed."). The assertion that all returns to professional services firms must be merely the sum of all of the different partners' labor is counterfactual, and professional services firms should be under the same standards as any other business.

In light of these competing factors, a balanced solution would be to carry forward the value of such services—provided that the value is not already taxed under SECA—to future years for up to three years and apply it against other income of that entity without regard to the taxpayer's wage base limit. At first glance, this carry-forward may appear to be taxing capital and thereby violating the very policy that was used to defeat the other methods for normalizing the SECA tax base. However, the theory is that the income limitation in the early years is essentially the sum of income from the value of the owner–employee's services provided, presumed to be the reasonable value of such compensation, netted against a loss from capital derived, more or less, from negative goodwill. So, in actuality, this carry-forward is merely correcting a timing difference by replacing income from capital with wage income subject to the SECA tax in order to recapture losses from capital that were deducted against the taxpayer's SECA tax base in prior years.

Recapturing the unused amounts of reasonable compensation in future years simply restores this balance so that reasonable compensation and capital income are taxed appropriately over time by eliminating timing differences manifest across a three-year window. If the entity consistently returns less income than the value of the owner–employee's services, then these lesser amounts should be deemed the proper amount of compensation for the services provided, and the carry-forward should expire once it falls outside the three-year audit window. This carry-forward strikes a careful balance between the interests of preserving the SECA tax base to the extent it would be eroded by arbitrary timing differences and treating fairly those business owners who consistently fail to achieve profits equal to the value of the services they provided. This approach could also be used across multiple entities to divorce the payroll tax calculation from the taxpayer's activities in each specific business and take a more holistic approach by considering all of the activities of the taxpayer in determining the reasonable compensation amount, not just the activities within specific ventures.

### C. Modifying the Definition of Net Investment Income to Correct the Loophole for S Corporations

For the reasons stated above, the exclusion of nonpassive income from the net investment income tax base should be eliminated, which could be accomplished by deleting section 1411(c)(2)(A) of the Internal Revenue Code, but a simpler revision would eliminate most loopholes applicable to the net investment income tax base if made in conjunction with the changes to SECA and FICA. The complexity of the current definition for net investment income is in part a result of the unnecessary complexity of the SECA and FICA tax base definitions.

Simplifying the SECA and FICA tax regimes based on a modified reasonable compensation standard provides the opportunity to close any of the corresponding loopholes in the net investment income tax base. The general definition under section 1411 for what is included in net investment income could be modified to simply include all income that is not otherwise subject to FICA or SECA taxes and then retain the exclusion of income subject to FICA and SECA under section 1411(b)(6). Additional specific exclusions, such as the exclusion of income from qualified plans, could then be added to this general definition as deemed appropriate.[156]

This is a particularly attractive approach in terms of increasing compliance because the maximum amount excluded from either Medicare or net investment income tax would be set by the net investment income tax floor. All income above the net investment income floor would be subject to a 3.8% rate regardless of whether it is subject to Medicare tax or net investment income tax. In other words, the incentives for a taxpayer to enter the battlefield for payroll tax avoidance would be substantially limited and the stakes would be substantially reduced.

### D. The Practical and Political Feasibility of This Proposal—How to Pay for and Pass It

The case for a modified reasonable compensation standard across all entities and taxpayers is strongly based on the original policy for payroll taxes, but it is equally important to consider whether the implementation of such legislation is practically and politically feasible. In terms of political feasibility, conveniently, Congress is in the preliminary phase of a bi-partisan effort to consider sweeping changes to the taxation of flow-through entities on the income tax side with a view toward simplifying and unifying S corporations and entities taxed as partnerships.[157] To the extent that these preliminary efforts successfully result in legislation, this would be the appropriate time to overhaul the payroll tax regime, as well. Even though the current proposals have not contemplated changes to the SECA tax regime, it would make no sense to unify the taxation of all flow-through entities for income-tax purposes but retain separate systems for determining the SECA tax base of S corporations, LLCs, and LLPs.

Another consideration that would be at the forefront of any such legislation is how this proposal would affect the federal deficit. There are a number of moving parts that would have varying effects on the federal budget, and determining such effects with precision is beyond the scope of this Article, as it would require another CBO study, but

156. *See* I.R.C. § 1411(c)(5) (2012).
157. *See* sources cited *supra* note 3.

considering the various effects suggests that this proposal could potentially be structured as revenue neutral. For instance, eliminating capital from the SECA tax base would represent a 42% reduction in the tax base,[158] which represents both a reduction in the tax base and a reduction in participation in social security. So, at least in theory, the lost revenues from this change would be at least partially offset. However, because the value of the burden imposed by social security now exceeds the expected future benefit from the program and the amounts going to Medicare are not linked to the benefits paid out, a reduction in participation would likely generate a gap requiring an additional source of funding or an additional reduction in benefits for this change to be revenue neutral. This proposal also provides for additional revenues in the form of (i) the SECA tax carry-forward, which would increase both revenues and participation in social security, as well as revenues for Medicare and (ii) closing loopholes in the net investment tax base, which would simply expand the tax base increasing Medicare revenues. To the extent that these changes represent a net increase in revenues for Medicare, the rate could even potentially be reduced to retain revenue neutrality notwithstanding a broader tax base, although such an option is unlikely given the current environment and concern over the federal deficit.

There are too many moving parts to determine the effect of these changes to the payroll tax system and the politics for achieving passage would vary significantly depending on how these numbers play out.[159] Using this modified reasonable compensation standard offers benefits both political parties may find sufficiently enticing to actually achieve enactment, particularly in an environment where lawmakers are already seeking to simplify and standardize the taxation of flow-through entities. At a minimum, conservative lawmakers could bill this as a payroll tax cut for small businesses functioning as tax partnerships that are overpaying their SECA tax liability compared to their corporate counterparts, and both conservative and progressive lawmakers could promote this as a bill that closes a loophole in the net investment income tax base and makes the overall tax regime more equitable. This would represent a rare combination of a political win-win that is also consistent with good policy. To the extent that these changes represent an increase in revenues for Medicare, then the rate could be reduced to retain revenue neutrality.

158. *See supra* text accompanying note 67.

159. This author is generally of the opinion that a sound policy-based recommendation should be made with at least some consideration for the likelihood of actual passage in order to be policy-relevant. *See, e.g.*, John S. Treu, *The Mandatory Disclosure Provisions of the Uniform Trust Code: Still Boldly Going Where No Jurisdiction Will Follow—A Practical Tax-Based Solution*, 82 Miss. L.J. 597 (2013).

## VII. CONCLUSION

For the reasons stated above, Congress and the IRS should implement a modified reasonable compensation standard with specifically articulated safe harbors and a carry-forward of untaxed compensation to standardize the SECA tax base with the FICA base for all taxpayers. Additionally, the definition for net investment income should be modified to include all income that is not currently included in the FICA or SECA tax bases to clarify the law and to close the loophole applicable to active income derived from S corporations in excess of the value of reasonable compensation.