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BREAKING THE GLASS SLIPPER –
REFLECTIONS ON THE SELF-EMPLOYMENT TAX

Patricia E. Dilley*

I. INTRODUCTION

Lawmakers and their staffs, in drafting tax legislation, often resemble Prince Charming looking for Cinderella with that glass slipper in hand—rather than start from scratch and draft a completely new tax provision. It is frequently easier, faster, and more reassuring to taxpayers and tax practitioners to use an existing statute or approach and simply amend it slightly to make it fit the need of the new provision. However, problems can arise from this approach.

In the original Grimm Brothers’ version of the Cinderella story, for example, the wicked stepsisters were each so anxious to be the chosen one that they mutilated their feet to make the Prince’s glass slipper fit.¹ In a similar fashion, existing tax laws designed to serve one purpose are occasionally bent to the breaking point to serve quite different ones, or are used as the model for tax provisions intended to satisfy other needs. The payroll tax—FICA or Social Security tax²—is an example of a tax model that may have been stretched beyond all recognition in the quite different context of self-employment. The central theme of this essay is that the shoe, in fact, may not fit at all, requiring some thinking about a different approach to a payroll tax equivalent for the self-employed.

The FICA tax is the neglected stepchild of tax policy analysis. Of little inter-

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¹Associate Professor of Law, University of Florida Frederic G. Levin College of Law; Swarthmore College, B.A., 1973; University of Pennsylvania, M.A., 1976; Georgetown University Law School, J.D., 1986; Boston University, LL.M., 1993. My thanks to Cecily Rock of the Joint Committee on Taxation staff for some illuminating conversations about SECA tax issues (although the faults of this essay are in no way attributable to anyone but myself). Thanks to my research assistants Karla Hyatt, Katherine Molnar, Josh Richardson and Leslie Thomson, and to the University of Florida College of Law for summer grant support.

est to theorists because of its relatively simple structure, and unpopular with tax policy analysts because of its regressivity, the FICA tax has received little attention in the tax literature, except to the extent it is implicated in the operation of its massively complex offspring, the earned income tax credit. The corollary of the FICA tax for the self-employed, the SECA tax, has been until recently an even more neglected element of the U.S. tax system. Of late, however, it appears that Cinderella has finally arrived at the ball, at least as far as practitioners, small business owners, and members of Congress are concerned, as agitation over the SECA tax and its application in a variety of settings has grown exponentially since the early 1990s. In fact, after forty years of shy obscurity in the corner, the self-employment tax over the last decade has become the life of the party, primarily because of changes both in the rate of application of the SECA tax itself, and in the way businesses have begun to organize themselves.

The central problem of the self-employment tax, however, has not changed:

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3The total FICA tax rate is currently 7.65 percent, a rate reached in 1990 as a result of the last in a series of increases in the tax rate enacted as part of the Social Security Amendments of 1977. The OASDI portion of the total rate is 6.2 percent, applied to all wages up to a "contribution and benefit base," equal for 2000 to $76,400, an amount which is indexed and increased each year according to the increase in average wages in the U.S. economy. Social Security Act Title II, § 230, 42 U.S.C. § 430 (2000). The remaining 1.45 percent is allocated to the HI program, and is applied to all wages with no limit, although up until 1993, the wage limit was the same for both the OASDI and HI portions of the tax. See discussion infra Part III.E (discussing the impact of this change on the level of concern with FICA and SECA taxes on the part of practitioners and their clients).

4See, e.g., JOSEPH PECHMAN, FEDERAL TAX POLICY 232-233 et seq (1987) ("The payroll taxes that are used to finance [Social Security] programs are used to finance these programs are regressive. In the long run, most of the payroll taxes are probably paid by the worker; it makes no difference whether the law imposes the tax on the employee or on the employer. The existing payroll taxes and the increases in tax rates already scheduled will have a major effect on the distribution of tax burdens. The equity of these taxes would be increased by improvement of the earned-income tax credit, introduction of personal exemptions and a standard deduction into the payroll tax and removal of the maximum taxable-earnings ceiling, integration of the payroll and income taxes, or use of the general fund for financing future social security benefits.").

5See generally Anne L. Alstott, The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform, 108 Harv. L. Rev. 533 (1995); see also George K. Yin, et al., Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program, 11 AM. J. TAX POL. 225 (1994). The earned income tax credit (EITC) was formulated in the 1970's generally to offset the regressive impact of the payroll tax, by giving a credit to low-income workers that effectively repays them for the FICA taxes they (but not their employers) have paid during the taxable year.

6The self-employment tax is imposed under the Self Employment Contributions Act (SECA). I.R.C. §§ 1401-1403. The SECA tax is imposed on self-employment income, which is defined in § 1402(b) as net earnings from self-employment (NESE). The same wage base limitations applicable to wages of employees are applicable to NESE. The income on which the SECA tax is assessed is recorded by the Social Security Administration as the earnings record on which Social Security benefits are based. Thus, eventual eligibility for Social Security retirement, survivors' and disability benefits, as well as Medicare benefits, generally requires ten years of net earnings from self-employment on which SECA taxes have been paid.

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how do we impose a wage tax when there is no employer-employee relationship to signify that wages as such are being paid? In point of fact, the SECA tax is not really a wage tax at all, but rather is a kind of income tax, on that part of the self-employed person's income that looks most like wages. However, to paraphrase Gertrude Stein, income is income is income. Earnings or wages cannot be distinguished from any other type of income except by the circumstances of receipt. The tax system frequently functions based on presumptions and circumstantial evidence that indicate the existence of one type of income or another, rather in the way astronomers detect black holes in space by noting the absence of other stars around them. For example, capital gains exist only in the context of a sale or exchange, just as compensation for services is presumed to exist (in the absence of other evidence to the contrary) whenever value passes from employer to employee.

This article sets out certain clusters of issues arising from the difficulty of applying the wage tax concept in the world of the undifferentiated income received outside the context of wage or salaried employment. It is my suspicion that the ultimate solution for perceived difficulties in identifying the appropriate SECA tax base, or the appropriate SECA taxpayers, may lie in the larger context of the Social Security payroll tax concept generally. The problem may not be so much deciding how to apply a tax to wages as it is whether to apply such a tax at all.

This article first examines the legislative development of the SECA tax, in the context of both tax and social welfare policy, as part of the post-World War II expansion of coverage and benefits under Social Security. The relationship between the taxing mechanism and the benefit system it finances has usually been neglected in discussions of the problems of the SECA tax. It is helpful, however, to understand how and why various groups were eventually covered under the system in order to think constructively about how the complex statutory structure of the current law might be revised. In addition, the development of the SECA tax rules applicable to pass-through taxable entities (partnerships, S corporations, and LLCs, as well as closely-held corporations in some circumstances) needs to be clarified in some detail, as most of the current controversies concerning the payroll tax have arisen in connection particularly with LLCs.

The next part of the essay is devoted to discussion of several points of focus in the general area of issues connected to the SECA tax, providing an examination of the issues from several different perspectives. It begins with the inherent

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8See discussion supra note 6.
9GERTRUDE STEIN, SACRED EMILY (1913) ("Rose is a rose is a rose is a rose.").
10Section 1221 defines the term "capital asset"; capital gain or loss arises, under section 1222, "from the sale or exchange of a capital asset."
11See, e.g., Alves v. Commissioner, 734 F.2d 478 (9th Cir. 1984) (holding that transferring stock from corporation to executive was compensatory transfer despite executive's payment of fair market value for stock).
functional conflicts within the SECA tax structure that arise in two areas: first, the use of a type of income tax to perform the functions of a wage tax; and second, the use of that tax structure both to collect revenue and to accrue benefits under Social Security for individual workers. Each of these conflicting objectives contributes to the complexity of the task of identifying self-employed workers and self-employment earnings.

Next, there is the problem of identifying the appropriate tax base to which the SECA tax should be applied, including both the current law structure, and two alternate approaches that can be taken. On one hand, it is possible to use an exclusionary approach, under which all income of the self-employed person would be excluded from the definition of “net earnings from self-employment” to which the SECA tax is applied except for that which can be clearly identified as earnings from the performance of services or the labor of the individual. Alternatively, an inclusionary approach would include all income of the self-employed person except that which can be clearly identified as income derived from capital (dividends or income analogous in character to dividends in a non-corporate context.) While the nominal distinction between these approaches is simply one of threshold presumptions, the substantive and procedural differences are significant and raise different problems.

Third, there is the issue of properly identifying the self-employed person. For example, how can one properly distinguish independent contractors from employees, or LLC members whose distributions of income are on account of labor or services rendered, from members whose distributions are in the nature of a dividend, constituting simply passive earnings on a capital investment? The latter distinction is linked to the previous issue of identifying the tax base, but somewhat different questions also are involved, related in particular to the benefit accrual function of the tax. Throughout these issues, the problem of separating wage income from all other types of income is the persistent unifying theme. The current response to this problem is to impose a sort of fictional employer-employee relationship on a single individual working independently. The following discussion may illustrate some of the dangers of this kind of legislating by analogy—that is, of imposing an artificial duality, drawn from the FICA tax model, on a single taxpayer.

After discussing each of these areas of concern, this article offers several modest suggestions concerning fruitful avenues of exploration for solutions to some of the most strident complaints about the SECA tax. As long as both benefit accrual and revenue collection are required SECA functions, any improvement is likely to be minimal. However, to the extent that the major SECA tax issues can be traced back to the elimination of the Medicare wage base, some

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13See Nationwide Mutual Ins. Co. v Darden, 503 U.S. 318 (1992) (adopting 20-factor common law tests for determining who qualifies as an employee); see also Vizcaino v. Microsoft Corp., 120 F.3d 1006 (9th Cir. 1997) (applying common law test of employee even where employer and employee signed contracts stating the latter was not employee but was independent contractor).

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proposals that do not involve changes in SECA itself might nonetheless resolve some SECA tax (as well as other) problems.

II. HOW DID WE GET HERE? BRIEF BACKGROUND

Before discussing the issues specific to the SECA tax and the current debate, some background on the Social Security system generally will be helpful. The difficulties inherent in applying the SECA tax to the appropriate measure of income and on the correct taxpayer all flow from the historic insistence on financing social insurance programs with a wage tax rather than an income tax. Some understanding of the historic development of both Social Security and the payroll tax system is a necessary (although frequently ignored) precondition to understanding why the wage tax is still viewed by many as a critical element of the current Social Security program.

A. Basic Benefit and Financing Structure

The Social Security system funded by employment taxes consists of three programs, as described above: retirement and survivors, disability, and health benefits. Eligibility for benefits under all of these programs is established through work in employment covered by Social Security. However, from the perspective of their financing and payment system structures, these programs can be viewed as falling into two categories: the cash benefit programs (retirement, survivors', and disability), the amount of whose payments are tied directly to an earnings record; and the health programs (Medicare Parts A and B), whose payments are tied to the cost of medical care without reference to the beneficiary's earnings record once initial eligibility for benefits is established.

The cash benefit retirement program was the original benefit provided under Social Security; survivors' benefits were added as part of the first major amendments to the Social Security Act in 1939, and the disability program was enacted in 1956. The health insurance programs, in contrast, were not enacted until 1964, and as part of the compromises necessary for enactment, were based on a reimbursement system involving private insurers and imposing no real limits on

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14See discussion supra note 2.
15As a result of work in covered employment, workers establish an earnings record on which their retirement, disability, and survivor's cash benefits are based. For both cash benefits and Medicare, a minimal period of employment, or earnings, covered by Social Security, is required: for basic eligibility for retirement benefits and Medicare, a worker generally must have at least 40 quarters (10 years) of earnings covered by Social Security to qualify for benefits. The exact number of quarters required varies with the worker's age, but all workers are fully insured for life once they have 40 quarters of coverage. For survivors' benefits, an additional currently insured status (earnings in 6 of the 13 calendar quarters preceding the worker's death) is required; for disability benefits, earnings in 20 of the 40 quarters preceding disability is generally required. See Social Security Act, 42 U.S.C. §§ 402, 413, 414 (2000). For the cash programs, the amount of benefits is generally a percentage of prior earnings, although the benefit formula is weighted to provide a higher level of replacement of prior earnings for low earners. See Social Security Act, 42 U.S.C. § 215 (2000).
the amounts of billings to be paid to physicians.\textsuperscript{17}

While Social Security benefits are not based on taxes paid, but rather on earnings recorded through the tax withholding system, there is nonetheless a direct link between the benefit and the financing systems in the cash benefit programs: benefits, as well as taxes paid, are based only on earnings up to the taxable wage base.\textsuperscript{18} In contrast, hospital and physician bills paid under Medicare are not tied to the worker's past earnings record, but rather are limited by a complex system of reimbursement designed to limit doctor and hospital costs.\textsuperscript{19} Because of the direct reimbursement character of the Medicare health payment system (as opposed to, for example, a system based on some form of cash voucher that could be used to pay medical bills), the nature of Medicare benefits cannot be expressed as a reflection of the beneficiary's earnings record in the way that cash benefits can. The only direct connection, therefore, between the Medicare benefit and revenue systems is the recording of earnings function of the payroll tax to the extent of establishing initial eligibility for benefits (in most cases ten years or forty quarters of covered employment).\textsuperscript{20}

**B. Expansion of Social Security Coverage to the Self-Employed**

The entire structure of Social Security—benefits and supporting taxes—is centered on the employer-employee relationship, a mirror of the overall U.S. private and public social welfare benefit system, which provides retirement and health benefits overwhelmingly through wage-based programs.\textsuperscript{21} Originally, however, coverage under Social Security did not extend even to all wage-earning workers; when established in 1935 as a system principally of retirement benefits for industrial workers, Social Security originally covered only a fraction of the

\textsuperscript{17}See Edward D. Berkowitz, Mr. Social Security: The Life of Wilbur J. Cohen 212 et seq (1995) (recalling the political struggles over the passage of Medicare from the perspective of one of the chief architects of Social Security and Medicare). Current limits on the payment system were inaugurated as part of the Social Security Amendments of 1983, Pub. L. No. 98-21, §§ 601-07, 97 Stat. 67, 149-72.


\textsuperscript{20}Workers generally acquire fully insured status, the minimum requirement for initial eligibility for benefits under Social Security's cash and non-cash benefit programs. Under § 414(a) of the Social Security Act, an individual will be fully insured if she has at least forty quarters of coverage. A quarter of coverage is defined in § 413 as the amount of wages paid to an employee or credited self-employment income for a self-employed person necessary to earn a quarter of coverage — this amount was set in 1977 as $250, indexed to increases in average total covered wages. For the year 2000, $780 in wages paid or net earning from self-employment (NESE) credited is required to receive one quarter of coverage — up to four quarters of coverage per calendar year may be earned. Thus, workers born in 1929 or later are fully insured for both Medicare and Social Security retirement benefits once they have worked in covered employment for ten years. Additional years of work in covered employment generally result in higher cash benefits in the retirement and disability programs, since benefits are based on a percentage of lifetime average earnings, but no additional benefit will accrue under the Medicare program.

nation's work force. Up until 1951, no self-employed workers were covered under Social Security and therefore were not subject to the FICA tax. This limited coverage was the result of both practical political limitations on the reach of the original program, as well as a philosophical framework that to some extent tempered the overarching principle of universal coverage with the notion of covering only those who seemed to most need pension protection.

One important practical consideration in the insistence on payroll tax financing to begin with was that few Americans paid any income taxes in the 1930s, or indeed until World War II and the post-war years. Social Security's designers insisted on a contributory system, in which all those earning benefits would provide evidence of their work record, and would be given a personal link to the program through direct payment of a wage tax dedicated solely to financing Social Security benefits. The payroll tax collected through the withholding mechanism was devised both as a means of financing benefits and as a symbolic link between covered workers and the retirement program. The wage tax was relatively easy to implement and enforce, given that wages were essentially defined by being exchanged in an employer-employee setting.

The principle of universal, compulsory coverage was an essential element of Social Security from the beginning, at least in the minds of its designers. However, the original 1935 legislation covered only workers in industrial wage labor, primarily because of political concerns about proposing a broader social insurance program that would impose difficult administrative burdens:

[T]he staff [of the Committee on Economic Security that originally drafted the first Social Security Act] pointed out the difficulties of basing contributions on any source of income other than wages or salaries and argued that wage earners were in the greatest need of protection. But they went on to state that administrative difficulties suggested further limitations, at least in the early years of a system. They suggested the exclusion of farm labor and domestic servants in private homes, despite their great need for protection, until after administrative experience was gained in less difficult areas of operation... Only in respect to the exclusion of profits, interest, or rents did the staff... indicate any justifica-
This "administrative expediency" was related to the circumstantial nature of the definition of wages, and the problem of identifying taxable wages for farm laborers and domestic servants, who received substantial portions of their remuneration in the form of room and board, on which it was difficult at the time to assess a payroll tax, given the paucity of cash resources, particularly for farmers. Since the income tax was largely not paid at the time by people at such income levels, the issues involving definition of such in-kind income as taxable income had yet to be fully explored, or at least had not been explored as extensively as they were in later cases.27

After World War II, Congress began to expand coverage under the program; many categories of self-employed persons were covered in a series of these expansions in 1950, 1954, and later.28 The expansion of coverage is attributable to several factors, primarily the maturation of the retirement system and the increasing cementation of the retirement expectation in the minds of the American public.29 The order of expansion of coverage to the various groups is significant. The coverage of farm and domestic workers occurred first in 1950, and is consistent with the original purpose of covering only industrial workers, which was to reach lower-income workers who were seen as needing Social Security benefits more than higher-income professionals.30 Then, beginning in 1954, Social Security coverage began to be expanded beyond wage earners in a traditional employment relationship, reaching self-employed farm owners and self-employed professionals except physicians and attorneys.31 By 1956, attorneys were no longer able to fight off inclusion in the Social Security system, and coverage was expanded to self-employed persons generally, except physicians,
as well as to farm owners who materially participated in farm operations. Finally, in 1965, shortly after enactment of Medicare, medical interns and self-employed physicians were covered.

The struggle to cover self-employed professionals reveals both the administrative difficulties of assessing the taxes necessary to support Social Security outside the context of an employer’s payroll—difficulties which are still evident in current SECA tax issues—and the philosophical ambivalence of the original designers over covering highly paid independent professionals who were much less likely to need Social Security in retirement than the originally targeted industrial workers. Eventually, for the policymakers, the principle of universal coverage—and universal taxation—outweighed doubts about extending the benefits of the program to high-earning professionals. Yet the resistance of the early Social Security designers to application of the payroll tax to “profits, interest, or rents” indicates the technical difficulties inherent in identifying wage-like income that should be subject to SECA.

An additional element was the difficulty of determining when the condition of retirement might begin for self-employed persons. Part of the change in work patterns from the nineteenth into the twentieth century was the gradual shift of most workers from self-employed farm or craft occupations into wage labor, creating the opportunity and the need for formal retirement, that is, for a clear-cut line between the end of a working life and the beginning of a period of unemployment lasting until death. Self-employed persons, in contrast, particularly farmers and professionals such as attorneys and physicians, were and continue to be better able to regulate their hours of work so as to blur the distinction between work and retirement.

For the professionals who resisted Social Security coverage in the 1950s, however, it was apparently self-interest, in the form of the advantages of obtaining retirement and disability coverage and benefits in exchange for paying what was at the time still a relatively low tax rate, that induced eventual acquiescence to coverage. Inevitably, perhaps, the current resistance to extending the reach

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34See discussion supra notes 26, 27.
35See ANN SHOLA ORLOFF, THE POLITICS OF PENSIONS: A COMPARATIVE ANALYSIS OF BRITAIN, CANADA, AND THE UNITED STATES 1880-1940 (1993). “Self-employment serves as an important barrier against forced retirement. Recent quantitative research has confirmed that wagework was increasing and self-employment was declining in the late 19th and early 20th centuries in the United States....The rise of wagework made all wage workers vulnerable to unemployment; for the elderly, this was often the equivalent of unpaid, forced retirement, a possibility simply not present for elderly people who owned land or small businesses. Farmers and small business owners were much better able than industrial workers to retire partially....” Id., at 99.
36The continuing evolution of the nature of work can only further blur these distinctions, not just between work and retirement, but between work and leisure at any age.
37See BROWN, supra note 24, at 62.
of the SECA tax to members of pass-through entities previously thought immune from that tax is driven to a large extent by the increase in tax rates for both FICA and SECA, and the perceived decrease in the value of Social Security benefits for this group.\footnote{See John W. Lee, A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do", 78 TEX. L. REV. 885, 930 (2000) (asserting that avoidance of payroll taxes is a principal reason for choosing pass-through business entities).}

\section*{C. SECA Tax Rates, Credits, and Deductions}

\subsection*{1. In General}

In addition to the expansion of Social Security coverage to the self-employed, the details of the structure of the SECA tax itself evolved over time. As described above, the Social Security tax and benefit system is based on the principle of equal contributions to the system from both the employer and employee; benefits are based on earnings records that reflect wages earned, but not necessarily taxes paid.\footnote{Payroll taxes are collected and paid to the government by the employer, not the employee, but if employers fail to pay the appropriate share of FICA taxes, employees can still be credited with the earnings credited for that period, as the Social Security Act contains no provision for denying coverage on the grounds of non-payment of taxes. See Social Security Act, 42 U.S.C. §§ 401, 411, 414 (2000).} When coverage under Social Security was extended to the self-employed in 1951, however, a different tax structure was required since there was no employer-employee wage-paying structure. Nonetheless, Congress determined that the self-employed must be taxed on a basis comparable to that of employers and employees—that is, "on remuneration received for one’s own labor."\footnote{See S. REP. No. 81-1669 (1950). This report accompanied House Report 6000, the Social Security Act Amendments of 1950, Pub. L. No. 734, which first imposed the self-employment tax.}

From 1951 through 1983, self-employed persons paid a rate that was approximately seventy-five percent of the combined employer-employee rate for the OASDI portion of the FICA tax, and fifty percent of the HI portion.\footnote{In 1951, the self-employed contribution rate was 2.25 percent when the combined employer-employee rate was 3 percent; in 1957 the SECA rate was 3.375 percent, and the FICA combined rate was 4.5 percent, reflecting enactment of the disability insurance program and a corresponding increase in rates; by 1966, the SECA rate had risen to 6.15 percent, and FICA had risen to 8.4 percent, reflecting enactment of Medicare. In 1982, the SECA rate was 9.35 percent, and the combined FICA rate was 13.4 percent.} This percentage was intended to represent the full employee’s share plus a rough estimate of the after-tax employer’s share of the tax;\footnote{See ROBERT J. MYERS, SOCIAL SECURITY 285-87 (4th ed. 1993).} as a result, self-employed persons were not allowed to deduct any portion of the SECA taxes they paid from their self-employment earnings for either income tax or SECA tax purposes.\footnote{Id.}

As part of a major reform of the Social Security system and its financing in the Social Security Amendments of 1983,\footnote{Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983).} the SECA tax structure was revised...
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to require self-employed persons to pay, in effect, “both halves” of the employer and employee shares of Social Security taxes.\(^4\) While a deduction for the “employer” share of the total rate seemed to be required for logic and parity of treatment, concern about short-term revenue shortfalls in the program (which were the impetus for the 1983 legislation) precluded immediate provision of a deduction.\(^5\) As a substitute for a deduction for SECA taxes paid, a credit for a portion of the tax, taken directly against the self-employment taxes paid, was allowed for taxable years 1984 through 1989, and a deduction for one-half of the self-employment tax liability was provided for 1990 and later years.\(^6\)

The SECA tax deduction\(^7\) is designed to put the self-employed worker, after both income and SECA taxes are imposed on self-employment earnings, in roughly the same position as an employee after income and FICA taxes are imposed on wage income.\(^8\) This is a complex task, since the equivalent of the FICA wage for the self-employed earner is a net figure, minus employer taxes imposed on self-employment income (SECA taxes).\(^9\)

As a result, there are two parts to the current statutory scheme.\(^10\) An income

\(^{4}\text{The 1977 Amendments set scheduled tax increases in 1982 to 13.4 percent, in 1985 to 14.1 percent, in 1986 to 14.3 percent, and 15.3 percent, in 1990, for a final increase. The major financing changes made the 1983 Social Security Act Amendments include acceleration of part of the payroll tax increases that had been enacted in 1977. As a result, part of an increase scheduled to take place in 1985 (which would have raised the combined FICA rate from 13.4 percent to 14.1 percent) was moved to 1984 (raising the rate in 1984 to 14 percent); similarly, the rate was scheduled to increase from the 1986 rate of 14.5 percent to its final rate of 15.3 percent in 1990, but the 1983 legislation inserted an interim increase from 14.5 percent to 15.02 percent in 1988. At the time of the amendments, a total of $39.4 billion for the period 1983 to 1989 was estimated to be raised by accelerating the scheduled tax increases for FICA, and $18.5 billion for the same period was estimated to be raised by increasing SECA tax rates.}\)

\(^{5}\text{See John A. Svahn & Mary Ross, Social Security Act Amendments of 1983: Legislative History and Summary of Provisions, SOCIAL SECURITY BULLETIN, July 1983, at 27-28.}\)

\(^{6}\text{The deduction for one-half of SECA taxes imposed under § 1401 was provided in § 164(f), also enacted in 1983 as part of the Social Security Amendments of 1983, but made effective for tax years beginning after 1989. Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983). The following table shows the combined impact of the SECA tax rates and credits for 1984-1990 and later:}\)

<table>
<thead>
<tr>
<th>Tax Years</th>
<th>OASDI</th>
<th>HI</th>
<th>Combined</th>
<th>Credit</th>
<th>Effective Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>11.40%</td>
<td>2.60%</td>
<td>14%</td>
<td>2.70%</td>
<td>11.30%</td>
</tr>
<tr>
<td>1985</td>
<td>11.40%</td>
<td>2.70%</td>
<td>14.10%</td>
<td>2.30%</td>
<td>11.80%</td>
</tr>
<tr>
<td>1986</td>
<td>11.40%</td>
<td>2.90%</td>
<td>14.30%</td>
<td>2.00%</td>
<td>12.30%</td>
</tr>
<tr>
<td>1987</td>
<td>11.40%</td>
<td>2.90%</td>
<td>14.30%</td>
<td>2.00%</td>
<td>12.30%</td>
</tr>
<tr>
<td>1988</td>
<td>12.12%</td>
<td>2.90%</td>
<td>15.02%</td>
<td>2.00%</td>
<td>13.02%</td>
</tr>
<tr>
<td>1989</td>
<td>12.12%</td>
<td>2.90%</td>
<td>15.02%</td>
<td>2.00%</td>
<td>13.02%</td>
</tr>
<tr>
<td>1990 &amp; later</td>
<td>12.40%</td>
<td>2.90%</td>
<td>15.30%</td>
<td>0%</td>
<td>15.30% (pre-deduction)</td>
</tr>
</tbody>
</table>

\(^{4}\text{I.R.C. §§ 164(f), 1402(a)(12). Section 1402(a)(12) is part of the definition of net earnings from self-employment under § 1402(a) generally.}\)

\(^{6}\text{H.R. CONF. REP. NO. 98-47, at 126 (1983).}\)

\(^{8}\text{See id.}\)

\(^{11}\text{Much of the following explanation is drawn from my New York University Federal Tax Institute outline, The Self-Employment Tax, Ch. 4, New York University's 54th Institute on Federal Taxation: Conference on Employee Benefits & Executive Compensation (1996).}\)

\(^{12}\text{Tax Lawyer, Vol. 54, No. 1}\)
tax deduction is allowed under section 164(f) for one-half of the self-employment tax imposed under section 1401, in recognition of the fact that employee wages do not include the employer share of the FICA tax. In addition, under Code section 1402(12), as part of the definition of net earnings from self-employment, a reduction is allowed in the self-employment tax base equal to the FICA tax (equivalent to one-half of the SECA tax) that would be paid on net earnings from self-employment (before any reduction under section 164(f)), again in recognition of the fact that employee wages do not include the employer share of the FICA tax.

It should be noted that this Rube Goldberg structure is necessitated, at least in part, by the SECA tax's imposition of a deemed employer-employee structure on workers who are outside of the traditional employment relationship. In contrast, the more flexible income tax structure is centered on receipt of income, from whatever source, by the individual. The borrowed FICA tax structure on which the SECA tax is modeled requires a fictional division of the individual into two parts—employer and employee—and then requires separation of "wage-like" income from all other types of income. Moreover, the need to impose more or less equal tax burdens on employees and self-employed workers puts additional pressure on the SECA tax design, resulting in the complex deduction mechanism.

2. SECA Tax Base

While the FICA tax is assessed generally on all wages in covered employment except for certain specifically excepted categories, the SECA tax is assessed on NESE: the self-employed person's gross income derived from a trade or business, minus allowable deductions attributable to that trade or business, plus her distributive share of the net income or loss from a trade or business carried on by a partnership of which she is a general partner or a limited partner receiving payments in connection with services rendered to the partnership.

Because the SECA tax is an analog to the FICA payroll tax for employees, the statute requires that only income "derived from a trade or business," minus
deductions associated with that trade or business, be included in the SECA tax base. Certain functions are excluded under the statute from the definition of trade or business for SECA purposes only; many of them parallel to the exclusions under the FICA tax for certain types of work, such as some public employment, not covered under Social Security. The definition of "trade or business" is generally the same as applied for income tax purposes, in connection with trade or business expense deductions under section 162. Determining whether or not an activity constitutes a trade or business requires consideration of all the facts and circumstances of the case.

While there is no statutory requirement for the active participation of an individual in the trade or business from which net earnings from self-employment are derived, the regulations state that passive earnings are not subject to SECA tax unless the trade or business is being actively carried on by an agent or employee directly on behalf of the taxpayer. Both the Service and the courts construe the "agency" requirement somewhat broadly, particularly in the context of a partnership, in the interests of preventing tax avoidance by partners who may actually be generating the income in question through actual services performed. This can lead to some results in which the revenue collection function of SECA seems to overtake completely the connection with benefit accrual, as in the case of Ethyle Moorehead who was ninety-two when the Tax Court found that she was liable for SECA taxes on partnership income because of services performed on her behalf by agents.

[58] In general, amounts that are excluded from income under the income tax will not be included in the base of income subject to SECA tax as net earnings from self-employment. Reg. § 1.1402(a)-2(a).

[59] The primary exclusions for SECA tax purposes include the functions of a public office, I.R.C. §1402(c)(1); performance as an employee as defined in § 3121(d), I.R.C. §§ 1402(c)(2) - (d); performance as a minister or member of a religious order, I.R.C. § 1402(c)(4); performance as a Christian Science practitioner, I.R.C. § 1402(c)(5); and performance of Services by members of religious groups opposed on the basis of religion to social insurance, e.g., the Amish, I.R.C. § 1402(c)(6).


[61] See Commissioner v. Groetzinger, 480 U.S. 23 (1987); see also, e.g., Batok v. Commissioner, 64 T.C.M. (CCH) 1605, T.C.M. (RIA) ¶ 92, 727 (holding that a retired mechanic who did a one-time job installing windows was involved in the conduct of a trade or business, and thus not subject to SECA tax on the payment for the job); Spiegelman v. Commissioner, 102 T.C. 394 (1994) (holding that a post-doctoral student who received an academic fellowship grant for independent scientific research did not as a result have gross income from self-employment, because it was not the product of a trade or business). Even though the university granting the fellowship had sent Spiegelman a Form 1099-MISC indicating the grant was "nonemployee compensation," and even though Prof. Spiegelman paid income taxes on the amount, the court concluded that the grant did not constitute earnings from self-employment subject to SECA tax because the professor was not required to perform teaching or other services for the university. While the language of § 117(c) requires inclusion in income of scholarship funds representing payment for research, the Tax Court found that research in this case did not constitute a trade or business, and therefore the grant was not net earnings from self-employment. Reg. §§ 1.1402-2(b), (c)-1.

[62] See Moorehead v. Commissioner, 66 T.C.M. (CCH) 149, T.C.M. (RIA) ¶ 93,314. Ms. Ethyle Moorehead was still in complete control of her financial affairs, including managing inherited interests in various oil and gas leases. The original agreement in 1946 between the corporation Tax Lawyer, Vol. 54, No. 1
Given the policy requirement that Social Security taxes be imposed generally on earnings from labor, as opposed to investment income, dividends and interest income are predictably excluded from the calculation of net earnings from self-employment, as such income is not analogous to employee wages. However, as discussed further below in the context of S corporation distributions, the Service will carefully scrutinize arrangements under the control of the taxpayer and will recharacterize dividends as wages under certain circumstances. Similarly, gains from the sale of property are excluded from the NESE base if the circumstances of realization fit the same general requirements as those required for characterization of income as capital gains rather than ordinary income.

Actually drilling and operating the wells and Mrs. Moorehead’s husband required him to perform a variety of acts in connection with the well operations. Twenty years after Mr. Moorehead’s death and the devise of his interests to Mrs. Moorehead, the leases were consolidated and sold to another corporation, and the owners, including Mrs. Moorehead, were operating the wells under a joint operating agreement which placed Mrs. Moorehead in a direct contractual relationship with the purchaser of the natural gas. On Mrs. Moorehead’s 1989 Form 1040 Schedule C, the income from the sale of the gas was listed as receipts from her business of wholesale oil and gas sales, but she did not pay SECA tax on the net profit. The Tax Court agreed with the Service that while Mrs. Moorehead was not personally active in the management or operation of the trade or business, her business was being carried on by agents on her behalf. The Court held that the taxpayer’s personal participation was not necessary for self-employment tax purposes, and that given the agreement in question, the business had been operated on her behalf through agents, which was sufficient to trigger SECA tax liability.

61.R.C. § 1402(a)(2). In addition, dividend or interest income received by a dealer in stock or securities in the course of conduct of a trade or business will be included in net earnings from self-employment for SECA tax purposes. Under Regulation section 1.1402(a)-5, interest on a loan made solely for investment purposes or not made in the ordinary course of a trade or business (presumably by a non-dealer), will not be included in self-employment income. Similarly, rentals from real estate, along with the deductions attributable to that activity, are excluded from the calculation of net earnings from self-employment, unless the income is received in the course of a trade or business as a real estate dealer. Reg. § 1402(a)-4(a). The regulations provide that payments for the use of rooms or other space where services are also provided to the occupant, such as hotels, boarding houses, warehouse space or storage garages, do not constitute rentals from real estate for purposes of this exclusion, and therefore are included in self-employment income. Reg. § 1402(a)-4(c)(2). The services rendered to the occupants in these types of rental situations are apparently what transforms this income from a type of passive income (for SECA purposes) into compensation for services that should be subject to SECA.

62The statute sets forth three circumstances for exclusion of gain or loss on the sale of an asset from self-employment income: gain or loss considered to be from the sale or exchange of a capital asset, I.R.C. § 1402(a)(3)(A); the cutting of timber or disposal of timber, coal or iron ore if § 631 applies to the gain or loss, I.R.C. § 1402(a)(3)(B); or the sale, exchange, involuntary conversion, or other disposition of property that is not inventory or held primarily for sale to customers in the ordinary course of the trade or business, I.R.C. § 1402(a)(3)(C). The statute specifies “sale or exchange” of a capital asset as producing income excluded from self-employment income. Thus, gains and losses from other types of dispositions (e.g., abandonment of property) may be included in the calculation of net earnings from self-employment if they are incurred as part of a trade or business. Note that the characterization of gain or loss as ordinary for income tax purposes (as in the case of section 1231 gains and losses, and depreciation recapture under sections 1245 and 1250) does not mean it is self-employment income for SECA tax purposes. Under the regulations, a casualty loss of trade or business property other than inventory cannot be taken into account as part of the net earnings from self-employment calculation. Reg. § 1.1402(a)-6.
3. Classification as Self-Employed

The definition of a trade or business under sections 1402(c)(2) and (d)\textsuperscript{66} excludes performance of services as an employee; remuneration from such employment will generally be subject to FICA taxes (imposing a tax burden on both employer and employee, and a collection and liability responsibility on the employer). Independent contractors, as defined under the common law twenty-factor test generally applied under the Code, are subject to SECA tax, and thus are responsible for payment of the full 15.3 percent tax on earnings. A full discussion of the independent contractor classification area is outside the scope of this article, but clearly classification is the threshold issue in determining application of the SECA tax.

D. Increasing Tax Rates, Disappearing Tax Ceiling

The final and most recent developments contributing to the current debate over the SECA tax are the increase in SECA tax liability for higher income taxpayers, the result of increases in Social Security tax rates beginning in 1977 but accelerated in the late 1980s, and the elimination of the wage base for the HI portion of the FICA and SECA taxes, combined with an increase in the formation of business organizations taxed on a pass-through basis in the 1990s.\textsuperscript{67} While taxes were increased both for FICA and SECA, in general employers and their employees subject to FICA have few options but simply to pay the taxes (although highly compensated employees newly subject to the Medicare portion of the FICA tax on all their income have increasingly sought to avoid it through nonqualified deferred compensation arrangements).\textsuperscript{68} For members of partnerships and LLCs, and shareholders in Subchapter S corporations, however, those entities appear to provide some shelter from at least part of this increased tax burden, and much of the controversy of recent years has arisen from disappointment over finding that their shelters may have some leaks.

Both FICA and SECA taxes are imposed on employee wages or net earnings from self-employment only up to the contribution and benefit, or wage base;\textsuperscript{69} as noted above, benefits under the OASDI portion of the Social Security Act are computed based on percentages of wages recorded each year up to the amount of

\textsuperscript{66}I.R.C. § 1402(c)(2)-(d).
\textsuperscript{67}See Frost, supra note 7, at 676 ("Since 1988, we have witnessed a dramatic change in the law of unincorporated business entities, including the evolution of limited liability companies (LLCs), limited liability partnerships (LLPs), [and] limited liability limited partnerships (LLLPs) . . .") See also Susan Pace Hamill, The Limited Liability Company: A Catalyst Exposing The Corporate Integration Question, 95 Mich. L. Rev. 393 (1996).

\textsuperscript{66}I.R.C. § 1402(c)(2)-(d).
the wage base. The principle underlying the contribution and benefit base is that Social Security should be only a base for retirement income, rather than a total source of income replacement in retirement.\footnote{See generally \textsc{Robert Myers}, \textit{Social Security} (1989).}

By limiting benefits to wages under the wage base, in combination with other program features such as the weighted benefit formula, the program's design assures that maximum Social Security benefits will never exceed the floor of income they were intended to be.\footnote{For example, the maximum Social Security benefit for a worker retiring in 1999 who had always earned at or above the wage base is $1568 per month or $18,816 per year; the maximum retired couple's benefit in 1999 was $2352 or $28,224 per year. Average benefits for a worker and spouse retiring in 1999 are about $15,000 per year. The Social Security Amendments of 1972 first provided for automatic cost-of-living increases for beneficiaries; the 1977 Amendments, which substantially revised the benefit formula to reduce benefits for future beneficiaries, provided also for an automatic wage base increase each year that a cost-of-living increase in benefits is paid to Social Security beneficiaries. In any year in which the cost-of-living increase for beneficiaries is calculated at less than 0.1 percent, no cost-of-living increase will be paid and therefore no wage base increase will be applied. In addition to the automatic wage base increases, ad hoc increases were made in several years prior to 1983. The wage base increase is determined by the increase in average covered wages for the previous year, as calculated by the Commissioner of Social Security under section 230 of the Social Security Act.} At the same time, indexing the wage base to the growth in average wages virtually guarantees an increase every year. This design ensured the dynamism of both the benefit formula and the revenue-raising scheme—beneficiaries are ensured a share of the increasing gross national product, while taxpayers are required to pay in taxes a commensurate share of the result of their increasing productivity that will rise with the increase in the wage base each year.

In addition, by enacting several ad hoc increases in the wage base before indexing it to the increase in average wages each year, lawmakers attempted to ensure that approximately eighty-five to ninety percent of all wages paid in the national economy would be covered by the wage base.\footnote{\textit{See House Comm. on Ways \& Means, 103d Cong., Overview of Entitlement Programs, 1994 Green Book,} at 79 [hereinafter \textit{The Green Book}] \textit{reprinted in Where Your Money Goes: The 1994-95 Green Book} (Brassey's Edition) (1994).} In that way, workers could be assured that retirement benefits under Social Security, designed to replace only forty-two to forty-five percent of the average worker's wage up to the wage base, would provide a reasonable, but not excessive, base to which private pensions and savings could be added to insure adequate income in retirement. In 1984, the OASDHI wage base was $37,800; for 2000, the OASDI wage base was $76,400.

These rationales for the level of the wage base are not particularly relevant in the context of the Medicare or HI portion of the FICA and SECA taxes. Since benefits provided by Medicare bear no relation to the level of previous earnings, the wage base limit could be perceived as providing a bargain to higher-wage taxpayers, since they were receiving the same Medicare coverage in retirement earned through a much lower percentage of their overall income while they were in the work force.
The first action to sever the HI portion of the FICA and SECA tax base from the OASDI portion was taken in the Omnibus Reconciliation Act of 1990, when Congress established a separate HI wage base of $125,000. The rationale for establishing the separate wage base for HI as stated in the report of the conference committee was to "improve the progressivity of the tax system. In addition, increased revenues under the bill will provide necessary funding for the Hospital Insurance Trust Fund and will enhance its long-term solvency." By 1993, the HI wage base had risen to $135,000, to which the 1.45 percent of the FICA tax attributable to HI would apply. The corresponding SECA rate for HI alone was (and remains) 2.9 percent.

As part of the Revenue Reconciliation Act of 1993, the wage base for the HI portion of the FICA and SECA taxes was eliminated; as a result, self-employed persons now are subject to the 2.9 percent HI tax on all net earnings from self-employment, and employees are subject to the 1.45 percent HI tax on all wages. The rationale for eliminating the wage base for HI, only two years after a separate cap was established, was essentially the same as in 1990—to improve progressivity, and increase revenues into the HI trust fund, which was projected at the time to be insufficient to pay its obligations as early as 2003.

Prior to the elimination of the HI wage base, FICA and SECA taxes were a limited issue for most highly compensated employees and self-employed persons. Now that the HI tax of 1.45 percent for employees and 2.9 percent for the self-employed is imposed on all earnings, however, the SECA tax has become a new focus for highly compensated self-employed persons. It is particularly important for those who previously would have had no employment taxes imposed on self-employment income from directors' fees or other secondary income sources if they had employee wages up to or over the FICA wage base from other employment.

As a result, tax planners have spent considerable time and effort over the last five years developing strategies for recasting income that might be considered self-employment earnings as passive types of income that are excluded from the

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7\textsuperscript{3}\textsuperscript{3}Omnibus Reconciliation Act of 1990, 104 Stat. 1388.
\textsuperscript{7\textsuperscript{4}}Committee Print; 101st Congress 2d Session; WMCP: 101-37.
\textsuperscript{7\textsuperscript{5}}Frequently, individuals will have both employee wages subject to FICA and net earnings from self-employment subject to SECA. Prior to the elimination of the HI wage base, an employee with wages in excess of the wage base would pay no self-employment tax at all on any additional net earnings from self-employment. Under current law, however, this holds true only for the 12.4 percent combined OASDI tax. Under sections 1401(a) and 1402(b)(1), the OASDI portion of the SECA tax continues to be applied only to net earnings from self-employment up to the amount of the OASDI wage base, minus the amount of employee wages subject to FICA. However, the HI portion of the SECA tax is now applicable to the entire amount of net earnings from self-employment, even if the taxpayer also has employee wages also subject to the HI tax. I.R.C. § 1402(b)(1). In any event, net earnings from self-employment that total less than $400 in any taxable year are exempt from SECA tax. I.R.C. § 1402(b)(2). A special floor of $100 is applicable under section1402(j) to income for services performed in the employ of a church or church-controlled organization which has properly made an election under section 3121(w).
\textsuperscript{7\textsuperscript{6}}The Green Book, supra note 72, at 178.

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net earnings from self-employment base, and for restructuring the forms of organizations so that earnings may be distributed as dividends rather than compensation for services. All of these strategies can be viewed as manipulating both the SECA tax base and the identifying characteristics used to detect a self-employed person on whose earnings the SECA tax should be assessed. But before addressing the theoretical issues involved in identifying both the SECA tax base and taxpayer, some attention should be paid to the particular complaints of the small business community, now largely organized as one or another type of pass-through taxable entity—partnership, S corporation, LLC, sole proprietor, or independent contractor.

III. SPECIAL PROBLEMS FOR PASS-THROUGH ENTITIES

The increase in SECA tax liability as a result of increasing overall rates, changes in the structure, and elimination of the HI portion of the wage base coincided with the development of a new business entity taxed on a pass-through basis—the limited liability company (LLC). The LLC originated in Wyoming in 1977 and, through determined and organized lobbying efforts by advocacy groups, was recognized under every state statute by the mid-1990s as an entity with corporate characteristics for purposes of state law (especially limited liability), but with sufficient partnership characteristics to qualify for pass-through taxation under the Internal Revenue Code.

While specific SECA tax rules applicable to partnerships, and thus to LLCs taxed as partnerships, were put in place in the 1970s, complaints surfaced only in the mid-1990s, when the HI wage base limit was eliminated. Despite the temptation to analyze the SECA tax as a question of disparate application to different types of business organizations, in fact all of the statutory, as well as regulatory, rules developed to deal with participants in pass-through tax entities are grounded in an attempt to discern the part of a self-employed person's income that is actually attributable to her own labor.

A. Shareholder/Employees of Closely Held and Subchapter S Corporations

The dividing line between employee and self-employed can become blurred when a principal or sole shareholder-employee of a closely held corporation

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77See Susan Pace Hamill, The Origins Behind the Limited Liability Company, 59 OHIO ST. L.J. 1459, 1460 (1998) (noting that the LLC originated in 1977 with the Wyoming statute); see also Fritz supra note 12, at 813, n.5 (noting that all 50 states plus the District of Columbia have LLC statutes).

78See Fritz, supra note 12, at 812.

79To some extent, this is a traditional inquiry in tax policy and legislative development, given the origins of the income tax and the early reluctance of the Supreme Court as well as legislators to tax "capital" directly. See Lester B. Snyder, Taxation With an Attitude: Can We Rationalize the Distinction Between 'Earned' and 'Unearned' Income?, 18 VA. TAX. REV. 241, 244 (1998). As demonstrated by the discussion above, however, the connection to Social Security benefit accrual makes the question of distinguishing between income from labor and income from capital less one of theoretical distinctions, and more one of political preference and administrative ease. What is easy in the FICA setting, however, becomes problematic in the SECA context.
receives compensation for services performed outside her regular duties. Frequently, prior to the elimination of the HI wage base, taxpayers would want any additional income above the wage base to be considered self-employment earnings, since no additional tax would be imposed under SECA and the earnings would constitute earnings for purposes of making deductible contributions to a retirement plan such as a defined contribution or defined benefit Keogh plan. In addition, if any compensation could be characterized as earnings from self-employment, the taxpayer could deduct expenses allocable to those earnings in arriving at a net amount subject to SECA, a degree of flexibility unavailable to employees. The Service has frequently challenged taxpayers’ assertions that amounts received from a corporate employer by an employee-shareholder could be anything but employee wages.

Since the elimination of the HI wage base, however, the 2.9 percent tax due offsets most incentives to claim this income as earnings. In general, an S corporation shareholder’s distributive share of corporate income will not be included in net earnings from self-employment. However, an S shareholder who is an officer of the corporation and who also performs substantial services for the corporation will be considered an employee whose reasonable compensation is subject to wage withholding under FICA.

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**Footnotes:**

80See I.R.C. §§ 401(c)(1), 404(a)(8)(c).

81In *Jacobs v. Commissioner*, the Tax Court examined the case of a sole shareholder and CEO of a corporation owning two gas stations, from which the taxpayer received “compensation” payments which he reported as self-employment income subject to SECA. The taxpayer also worked for another corporation, a gasoline distributor, of which he and his parents each owned one third, and from which he received a salary which he reported as wage income subject to FICA. The taxpayer’s deduction for contributing a substantial portion of the income reported as self-employment income was denied by the Service on the grounds that he was an employee of his wholly owned corporation and therefore was not eligible to make deductible Keogh contributions. The Tax Court agreed, saying that even though the taxpayer’s compensation at issue was nominally a director’s fee, it was actually paid to him in compensation for substantial services performed for the company, which made him an employee rather than an independent contractor. Jacobs v. Commissioner, T.C.M. (CCH) 1470, 1993 T.C.M. (RIA) § 93,570. Similarly, in a recent private letter ruling, the Service found that the taxpayer who, along with his wife, owned 100 percent of a corporation of which he was the president and manager, was in fact an employee of the corporation, and amounts received as “management fees” were wages rather than self-employment income. See P.L.R. 1995-30-005 (July 28, 1995). The key issue, as in the line of revenue rulings on which the Service relied, was the extent and substantial nature of the services performed for the corporation by the shareholder-director. See also Rev. Rul. 71-86, 1971-1 C.B. 285; Rev. Rul. 73-361, 1973-2 C.B. 331; Rev. Rul. 82-83, 1982-1 C.B. 151.


83Rev. Rul. 73-361, 1973-2 C.B. 331 (holding that an officer-shareholder of an S corporation who performed substantial services for the corporation in exchange for cash remuneration was an employee of the corporation whose wages were subject to FICA tax). See also IRS Publication 589 at 7. Even in cases where the taxpayer does not characterize as wages an S corporation distribution in connection with services, the Service can recharacterize such distributions. See Radtke v. United States, 712 F. Supp. 143 (E.D. Wis. 1989) (holding “dividends” received by S corporation sole shareholder and full-time employee, who drew no salary, to be wages subject to FICA tax), *aff’d per curiam*, 895 F.2d 1196 (7th Cir. 1990); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990) (holding distributions characterized as dividends to non-salaried shareholder, president, treasurer, director, and employee of S corporation to be wages subject to FICA tax).

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The distinction between distributions as dividends and distributions as earnings creates a somewhat arbitrary distinction, for FICA and SECA purposes, between sole proprietors who incorporate and obtain S corporation tax status and unincorporated sole proprietors. A sole proprietor ordinarily will have all earnings from her trade or business included in NESE for purposes of SECA taxes. As a general rule, however, S corporation shareholders normally will be taxed on the corporation's income as ordinary net income, but not as earnings for FICA or SECA purposes.

Employees of the S corporation will receive wages subject to FICA tax, and, therefore, where a shareholder behaves in a fashion that would lead to a conclusion that her relationship is actually that of performing services for the S corporation, employment taxes will be assessed. Thus, the Service will rely on the normal indicators of corporate relationships to determine the payroll tax treatment of business income, but these assumptions are backed up by the normal administrative scrutiny of taxpayer characterizations, and substance will trump form where appropriate. The presumption, in this case, is against a finding of wages in the S corporation setting.

B. Partners in Limited Partnerships

Partners in limited partnerships, in contrast, are subject to specific, special treatment under the SECA tax, in recognition of the different roles limited and general partners have traditionally been required to play in their partnership businesses, as a matter of state partnership law. General partners traditionally have been active managers in the running of the partnership's income-producing activities, while limited partners have been the passive investors, resembling traditional investors more than proprietors of a business. Thus, the FICA-SECA tax treatment of partnership income has relied on assumptions, once again, about the relationship between the partner and the business as the indicator of whether or not wages are being paid.

The normal rule is contained in section 1402(a), which generally includes in the definition of net earnings from self-employment a partner's distributive share of the net income of the partnership derived from the partnership's trade or business. This provision also allows distributive shares of partnership losses from the partnership's trade or business to reduce net income from self-employment. A partnership, for purposes of section 1402, has been interpreted broadly to include any organization other than a trust, estate, or corporation which is

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84Income of an S corporation retains its character as trade or business as it is attributed to S corporation shareholders in accordance with their interests in the corporation. I.R.C. § 1366(b). Congress reaffirmed this pass-through tax characteristic in the Small Business Job Protection Act of 1996, which provided, among other things, for pass-through treatment of S corporation distributions during loss years. Pub. L. No. 104-188, § 1309, 110 Stat. 1755, 1783-84.

85See Fritz, supra note 12, at 848.

86I.R.C. § 1402(a).

recognized as a partnership for federal tax purposes, regardless of the organization's status under state partnership law in the state in which the partnership is organized.\(^{88}\) In order to trigger SECA tax on the partners' distributive shares of income, the partnership itself must be engaged in a trade or business.\(^{89}\)

Prior to 1978, a partner's distributive share was includible in net earnings from self-employment regardless of the nature of her partnership interest; thus both general and limited partners were subject to SECA taxes even if the limited partner performed no services for the partnership. The only exception was for retirement payments made to partners, provided that the partner performed no services for the partnership, the partner's capital share had been paid out in full, and the retirement payments were the only obligation of the other partners to the retired partner.\(^{90}\)

However, Congress became concerned about the establishment of limited partnerships in the 1970s as investment vehicles, the chief purpose of which was to earn insured status under Social Security (and Medicare) for older investors who may not have been covered under the system during their working lives, such as professionals and government employees. Thus the Social Security Amendments of 1977 provided that, beginning in 1978, limited partners would not be subject to SECA tax on their distributive shares of partnership income, so long as the amounts received were not guaranteed payments under section 707(c)\(^{91}\) for services performed by the limited partner.\(^{92}\) This change was made at a time when the value of Social Security benefits was still widely perceived to outweigh their tax cost, given the relatively low tax rates and the application of the tax rate only to income up to the wage base.

Thus, general partners who may have no personal involvement in the partnership's trade or business may still be subject to SECA tax on their distributive shares of partnership income, while limited partners will not be. A partner who has both a general and limited partnership interest in the partnership can use the allocation process either to minimize self-employment income (by performing services only in his general partner capacity so that only that distributive share will be considered self-employment income), or create self-employment income for purposes of deferral into a retirement plan (presuming that his income tax savings from deferral will exceed the 2.9 percent HI portion of the SECA tax now applicable to the entire amount of self-employment earnings).

\(^{88}\)Reg. § 1.1402(a)-2(f).
\(^{89}\)Reg. § 1.1402(a)-2(d). See Rev. Rul. 75-525, 1975-2 C.B. 350 (holding distributive share of income from investment partnership to not be self-employment income); see also Calvert v. Commissioner, 45 T.C.M. (CCH) 69, 1982 T.C.M. (RIA) ¶ 82,649.
\(^{90}\)I.R.C. § 1402(a)(10).
\(^{91}\)I.R.C. § 707(c).
\(^{92}\)I.R.C. § 1402(13). Apparently, payments received by a limited partner based on capital invested in the partnership would not constitute net earnings from self-employment. Presumably only the limited partner distributive share would be excluded for a partner who is both a limited and a general partner.

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While in most cases a written partnership agreement conforming with either the general or limited partnership statute of the state of operation will clearly indicate the existence of a partnership, in many instances a less formal combination of taxpayers doing business together, or controlling investments together, may constitute a partnership for tax purposes generally. In light of the different treatment of limited and general partners for SECA tax purposes, the finding that an interest in a joint venture is a general partner interest will lead to SECA tax liability.93

C. Members of Limited Liability Companies

1. In General

Limited liability companies (LLCs) are rapidly becoming the preferred alternative to both S corporations and partnerships as a form of organization that provides many of the flow-through tax benefits of a partnership while providing the shelter from personal liability for members that was previously available only to corporations.94 All states have enacted LLC statutes providing specific guidelines for LLC agreements and operations, and the Service has issued guidelines allowing taxpayers to choose to have an LLC treated for federal income tax purposes as either a partnership or an association.95 The SECA tax treatment of LLC members continues to be the most controversial aspect of both the LLC and the SECA tax areas, and the Service has issued two sets of proposed regulations on the subject that are still under debate. Considerable uncertainty continues to exist regarding to the SECA tax treatment of the distributive shares of

93This issue has arisen repeatedly in the oil and gas leasing context (as in Moorehead, discussed supra note 63). For example, in Johnson v. Commissioner, the Tax Court held that income from working interests in an oil and gas venture was earnings from self-employment, despite the lack of active participation of the taxpayer in question in the operations. The court deemed the owners of these interests to have formed a general partnership as defined under section 7702, but not a limited partnership, as their arrangement did not meet the state law requirements for limited partnership status. This result was reached despite the taxpayer's partially limited liability under the terms of the agreement, and her lack of active participation. Johnson v. Commissioner, 60 T.C.M. (CCH) 603, 1990 T.C.M. (RIA) ¶ 90,461. The Service has attempted to apply the requirements for formation of a limited partnership very strictly, as in the case of Gamma Farms v. Commissioner. In this case, the partnership had intended to be a limited partnership, and had followed all the steps required for limited partnership status except for filing the required Certificate of Limited Partnership; when this error was discovered, a correct Certificate was filed the following year. The Service and the district court maintained that because of this failure, the taxpayer-partner would have been liable to creditors as a general partner and therefore the exception from SECA tax liability under section 1402(a)(13) was not applicable. The Ninth Circuit, in overturning the district court, held that the focus should be on the actual limited liability of the taxpayer under the agreement, and that in light of the clear good faith attempt to comply with state law requirements for limited partnerships, and the corrected filing, creditors would have been on notice of the taxpayer's limited liability. Therefore, the taxpayer was held to be a limited partner and thus not subject to SECA tax under section 1402(a)(13). Gamma Farms v. Commissioner, 956 F.2d 1166 (9th Cir. 1992).

94See Hamill, supra note 77; see also Lee, supra note 38.

95The so-called "check-the-box" regulations issued under section 7701 provide that LLCs can be treated as either partnerships or associations, except for single member LLCs, which are treated as sole proprietorships. Treas. Reg. §§ 301.7701-2(a), -2(c)(2), -3(a), -3(b)(1)(ii).
income of LLC members, since there is no "limited" or "general" distinction between members, who thus receive little guidance from the SECA rules applicable to limited partnerships.96

In 1994, the Service ruled that, in the case of a conversion of a general partnership into an LLC in which all of the partners would continue to be actively engaged in the business just as before the conversion, the distributive shares of LLC income and loss as described in section 702(a)(8)97 would be includible in computing net earnings from self-employment under section 1402,98 and would be subject to the SECA tax.99 The Service based its ruling on an interpretation of Regulation section 1.1402(a)-2(f),100 which provides that, for the purpose of determining net earnings from self-employment, a partnership will be considered as such if it is recognized as one for income tax purposes under section 7701.101 Since the LLC in question was ruled to be treated as a partnership for income tax purposes, the members of the LLC would be considered partners for SECA tax purposes. Therefore, their distributive shares of LLC income and loss would be includible in determining net earnings from self employment, and subject to the SECA tax, because section 1402(a)(13)102 did not exclude them.

The Service did not give a specific basis for its determination that section 1402(a)(13)'s exception for limited partners did not apply to these LLC members. However, it can be inferred that the critical factors in the ruling were the LLC agreement's designation of each member as a manager of the LLC, the exclusion of non-members of the LLC from manager status, and the continued active conduct of the business of the LLC by the members. The state statute under which the LLC was organized required that the business affairs of an LLC be run by managers, each of whom was a natural person.

2. 1994 Regulatory Clarification

On December 28, 1994, the Service issued a notice of proposed rulemaking and a notice of public hearings on Proposed Regulation section 1.1402(a)-18(c)(3),103 which addressed the SECA tax treatment of LLC members. The proposed regulation allowed an LLC member to be treated as a limited partner for the purpose of the exception for limited partners provided in section 1402(a)(13), but only if the member was not a manager of the LLC, the LLC could have been formed as a limited partnership under the laws of the jurisdic-

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96 Similar interpretive problems exist under other provisions of the Code, such as section 469(h)(2), providing a special rule for passive losses of limited partners.
97 I.R.C. § 702(a)(8).
98 I.R.C. § 1402.
100 Reg. § 1.1402(a)-2(f).
101 I.R.C. § 7701.
102 I.R.C. § 1402(a)(13).
tion, and the member could have qualified as a limited partner in such a limited partnership in that jurisdiction.

The proposed regulation defined the term "manager" as a person who, alone or together with others, was vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there were no designated or elected managers who had continuing exclusive authority to manage the LLC, all of the members would be treated as managers, regardless of any variations of management authority among the members under either the applicable LLC statute or the LLC's controlling documents.

The explanation accompanying the proposed regulations stated that these requirements were designed to insure that the treatment of LLC members who participate in the management of the LLC was consistent with the treatment of limited partners, who might have became liable for the obligations of the limited partnership if they became actively involved in the business of the limited partnership. The regulation also appeared to be designed to insure that LLC members could not obtain a result for self-employment tax purposes that they could not achieve through operation as a limited partnership in the same jurisdiction (if, for example, the state law prohibited the conduct of certain activities through a limited partnership).

3. 1997 Approach and Furor

The 1994 proposed regulations proved somewhat controversial, and the Treasury Department withdrew them in early 1997, substituting new proposed regulations, which were scarcely less controversial than the original rules. A key issue that the Service struggled with in developing its new proposals was whether to impose an actual "service" test to determine whether self-employment taxes should be imposed, as had been suggested in several quarters.

The 1997 proposed regulations, on which Congress placed a moratorium in August of 1997, but which never have been withdrawn, essentially maintain the current law exemption from SECA taxes for limited partners. The regulations address the LLC issue by extending limited partner status to all members of entities treated like limited partnerships, including LLCs, regardless of whether the individual would be viewed as a limited partner under applicable state law, unless a different status can be demonstrated. The Service terms this rebut-

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106Congressional Republicans attacked the proposed regulations, calling them a "stealth tax increase" on small businesses. See Fritz, supra note 12, at 848 n.131.
table presumption of limited partner status “a functional approach,” designed, apparently, to provide uniform treatment for members of both partnerships and LLCs. The tests or “standards” which, if applicable to a member of a partnership or LLC, would result in reclassification as a general partner whose distributive share of entity income would be subject to SECA, are (1) personal liability for debts of the partnership or LLC; 2) authority under applicable local law to contract on behalf of the partnership; or (3) participation in the partnership’s trade or business for more than 500 hours during the partnership’s taxable year.

These regulations would provide an escape hatch even for those members of partnerships or LLCs who do qualify for SECA tax treatment under these standards, at least for that part of their NESE that could be classified as a return on capital invested in the partnership. Essentially, the approach of the regulations is to allow for the possibility of possession of different types or classes of interests in a partnership or LLC, and for exclusion, as return on investment capital, of income attributable to an interest that essentially looks like a limited partnership interest. These exclusion provisions would apply if two conditions were met upon acquisition of the class of interest to which limited partner treatment would attach: the class of interest must be one in which true limited partners (who qualify for such treatment without regard to these special exceptions) own a substantial and continuing interest, and the rights and obligations must be identical for true limited partners and the partner seeking to qualify for limited partner treatment under these rules.

Significantly, however, the proposed regulations also exclude “service partners in a service partnership” (such as one involving the performance of legal, medical, accounting, or other types of professional services), regardless of the partnership’s identification under state law as a limited partnership, from treatment as limited partnerships under section 1402(a)(13) and thus from the reach of the proposed regulations. The proposed regulations do provide a de mini-

mis activity exception to the “service partner” definition, but offer no definition of “substantially all” of a partnership’s activities that might trigger the exception for such a partnership.119

D. Reactions and Other Proposals

Many analysts welcomed the general approach of the regulations as an attempt by the Treasury to provide a uniform approach, not tied to state partnership or other legal definitions, for members of all entities treated like partnerships under federal tax law.120 However, the exclusion of “service partnerships” from the presumption that entity income is not services income that should be taxed under SECA helped to create a firestorm of opposition to the regulations, and eventually led to the moratorium enacted in 1997.121 Since the issuance of the proposed regulations, the American Bar Association Section of Taxation has written to Congress with a legislative proposal in reaction to the proposed regulations.122 In June, 2000, the American Institute of Certified Public Accountants (AICPA) also wrote to Congress supporting the ABA’s proposal and urging immediate legislative action to address the SECA tax issue.123

The ABA’s proposal would amend section 1402(a)(13) to provide that income from any type of entity, to any participant in that entity (general or limited partner, member or manager of LLC, etc.), that is “attributable to capital” would be exempt from SECA taxes. This proposal contains two safe harbors for determining income attributable to capital: either an amount in excess of reasonable compensation for services rendered by the partner (or person treated as a partner), or an amount equal to a reasonable rate of return on that partner’s capital contribution to the enterprise would be treated as return on capital rather than as income subject to SECA.124 Other analysts have developed similar approaches.125

What is interesting about this approach is that it attempts to divorce the tax treatment of certain persons from the common law definitions and assumptions about what those persons—limited partners, for example—do in the context of

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120See Burgess J.W. & William L. Raby, Partners, LLC Members and SE Tax, 87 TAX NOTES (TA) 665, 667 (May 1, 2000).
121Id.; see also supra note 106.
122See ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Tax, TAX NOTES TODAY (July 13, 1999) (LEXIS, FEDEX lib., TNT file, elec. cit. 1991 TNT 133-23) [hereinafter ABA Tax Section Letter].
123See Letter from David A. Lifson, Chair, Tax Executive Committee, AICPA to Sen. William Roth, members of the Senate Finance Committee and Cong. Bill Archer, Chairman of the House Ways & Means Committee (June 22, 2000) (on file with author) (“The AICPA had submitted a similar legislative recommendation to Congress in February of 1998 and would now like to express its support for the ABA’s 1999 recommendation.”)
124See ABA Tax Section Letter, supra note 122.
125See, e.g., Fritz, supra note 12, at 861 (noting that approach based on a rebuttable presumption that a member of a passthrough entity is an investor with returns on capital that should not be subject to SECA would be established).
their partnership activities. It thus addresses the problem created by the very specific language of the current statute and regulations which only define terms in the partnership setting; the problem of what to do with LLC members' income is not solved by treating the LLC as a partnership under the general classification rules, since the SECA tax provisions reference only "partners" and "partnerships," not "all entities treated like partnerships under the Code."126

However, both the 1997 proposed regulations and the ABA-proposed legislation demonstrate that any method of identifying self-employment income is necessarily based on assumptions about the relationship of the individual to the entity producing the income. The differences among proposed approaches essentially revolve around what outward indicators—state law partnership definitions, presumptions about what limited partners can or cannot do, assumptions that material participation signifies a wage-earning activity—are used to identify returns on labor rather than on capital.

It should be noted that long before the controversy involving LLCs emerged (indeed, long before LLCs themselves were even a gleam in the Wyoming legislature's eye), the Treasury Department, in the context of major tax reform proposals, had suggested that an S corporation shareholder's distributive share of income be treated as trade or business income, a treatment similar to that afforded both general partners and unincorporated sole proprietors.127 Without further limitation, this would have resulted in all flow-through income being subject to SECA tax, thus in all likelihood subjecting some income from capital to SECA tax. This kind of approach might well be applied in the LLC context, and constitutes the opposite end of the spectrum of approaches from the ABA/AICPA proposals.

IV. CORE ISSUES AND ANALYSIS

A. In General

There are two basic approaches to take in determining whether a self-employed person's income or a portion of it is properly taxable under SECA. First, the statute or the regulations could incorporate an assumption on the basis of some observable category (relationship to entity, for example) that leads to an

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126 See Frances Cokes v. Commissioner, 91 T.C. 222 (1988), in which a venture that did not meet the state statutory definition of a limited partnership was found by the Tax Court to produce straightforward trade or business income to a passive investor, all of which income was therefore subject to SECA taxes. Because of this and other decisions like it, the Rabys point out that "LLCs and limited liability partnerships are not 'limited partnerships' under state law . . . since 'limited partners' is not being used, say the Tax Court cases, as a generic description of partners who are in some fashion limited as compared to other partners. Rather, say these cases, a 'limited partner' is one defined specifically as such in a state limited partnership statute. How, then, can it even be argued that members of LLCs and partners in LLPs are nevertheless 'limited partners' for purposes of section 1402(a)(13)?" Raby & Raby, supra note 120.


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automatic result—either to tax or not to tax. Second, and alternatively, the
Commissioner could be required to engage in a facts and circumstances test for
each and every taxpayer and for each and every item of income in order to make
precise judgments. A third way would be some combination of these approaches,
which is essentially what is used under current law and regulations. These choices
are, of course, emblematic of the choice between simplicity and equity that must
repeatedly be made in devising tax provisions.\textsuperscript{128}

Most analysts have suggested that the SECA tax issue is a problem of rules
that improperly tax different business entities differently and unfairly. Their
response, as discussed above, has generally been to propose reforms of which
the principal objective is uniformity of taxation of members of different types of
pass-through entities, to be achieved by largely excluding income of all partici-
pants from such entities unless it can be demonstrably connected to wage-earn-
ing activity.\textsuperscript{129} The current rules, complex though they are, will not be much
improved upon by any of these suggested reforms without substantial exclusion
from SECA taxes of income that would be taxed under current law.

The complications of current law, and the Treasury Department’s proposed
regulations, are required by the underlying imperative to tie Social Security
benefit eligibility to earnings. The difficulties are created by the lack of an
employer-employee relationship, which is normally the signifier of wages paid
on account of services rendered. In the absence of such an outward marker, it is
difficult, if not impossible, to distinguish with absolute certainty between wages
and income unconnected with services, such as income from capital of various
types.\textsuperscript{130}

One problem with past examinations of the SECA tax issue is that most have
concentrated on the effects of the assumptions that must be made in order to
make what is essentially an income tax perform the functions of a wage tax. It is
almost inevitable that different organizational forms will result in different SECA
tax consequences if the purpose of the rules is to determine the real character of
income flowing from a business entity without having to make a facts and
circumstances test in each case. The result of such analyses has generally been
to suggest even more extreme assumptions about income flowing through pass-
through entities—either that it is all is trade or business income and subject to
SECA\textsuperscript{131} or that all of it is presumptively return on capital and not subject to

\begin{footnotes}
\item [128]See Pechman, \textit{supra} note 4.
\item [129]See Fritz, \textit{supra} note 12, at 812-13 ("Current self-employment tax laws trigger varying results
for individual owners of different forms of business. In addition, application of these disparate rules
is based, at least in part, on ownership status rather than employment-related activities. Further, the
self-employment tax often is imposed in a manner inconsistent with the basic principles underlying
application of the employment-related tax laws.").
\item [130]See Jane Gravelle, \textit{The Economic Effects of Taxing Capital Income} (1994) ("While wage
taxation may appear to be quite straightforward, it is extremely difficult – indeed, probably impos-
sible – to separate capital income from labor income for closely held businesses where the owner
may supply both capital and labor services. (The current payroll tax simply ignores this problem and
thus taxes some of the capital income of these businesses."); see also Snyder, \textit{supra} note 79
(discussing the difficulties of separating earned and unearned income).
\item [131]See Tax Reform Hearings, \textit{supra} note 127.
\end{footnotes}
REFLECTIONS ON THE SELF-EMPLOYMENT TAX

SECA. 132

The following discussion, in contrast, organizes SECA tax issues around three different central conceptual difficulties, in an attempt to provide a slightly different framework for analysis of the choices for reform. One way to approach the analysis is to focus on the self-employment tax’s inherent conflicts, in both its functions and its conceptual framework. A second approach is to examine the difficulty of clearly identifying the SECA tax base, to which there seem to be two possible approaches, exclusionary and inclusionary. Finally, there is the difficulty of properly identifying the SECA taxpayer, which has been approached traditionally by relying, in the tax law, on non-tax law categories that have been assumed to be clear indicators of the individual’s functional relationship with the business entity.

B. SECA’s Internal Conflicts

The first key to deciphering the problems of the SECA tax generally is to recognize at least two inherent dualities in the conceptual framework of the system. First, the SECA tax is both a revenue collection device and a benefit accrual system, just like the FICA tax on which it was modeled. The problem is that the presumptions that have worked fairly well in the FICA context since the 1930s are not particularly applicable in the SECA context. Second, the SECA tax is an income tax that is required to perform like a wage tax—again, the FICA tax model has been imposed on fluid working and investment relationships and entities that do not fit squarely into the preexisting notions of what wages are and how they are paid.

1. Dual Functions – Collecting Revenue and Benefit accrual

The Social Security system was established with a clear presumption that a public retirement income support program was politically sustainable only if it was seen to, in some sense, belong to the workers for whom it was to provide benefits. A contributory wage tax, dedicated solely to financing Social Security benefits, made political sense, because it was thought that it would create an immediate and direct connection between the taxpayer and the benefit system. Moreover, since contributory pensions and annuity policies were a fairly well understood concept, the idea of contributing to one’s future retirement security in the public setting was made less novel by linking it, through the sort of living analogy of the payroll tax, to more traditional and accepted concepts of life insurance policies and pension annuities. 133

132 See Fritz, supra note 12, at 850-853.
At the same time, the entitlement to benefits itself was seen as critically connected with a life of work and contribution to society as a laboring individual, in contrast to entitlement based on need. The latter was rejected as a basis for the social insurance benefit, not surprisingly given the long history of contempt for such needs-based benefits in American and, indeed, Western history generally. The practical consideration of how to keep track of individual workers’ quarters of work in covered employment, on which benefit entitlement would be based, merged with the need to collect the contributory wage tax directly from employees and their employers (as part of the dual contributory tax structure). Coupled with the consideration that very few wage workers paid any income tax in the 1930s, the practical result was the FICA withholding tax system, which gives a direct, tangible signal to workers that they are earning credit toward their eventual retirement benefit and contributing to the financing of the system as a whole.

It is important to recognize that, although the benefit-accrual and revenue-collection functions, in the FICA context, are not necessarily contradictory in purpose or result, they are nonetheless different functions. FICA contributions (as well as SECA payments) are collected under the Internal Revenue Code, while Social Security benefits are based on earnings record and quarters of coverage requirements under the Social Security Act. The two sets of requirements are technically unrelated, and, in fact, eligibility for benefits is unconnected to actual payment of FICA or SECA taxes.

When one turns from the FICA system to the issue of those earning income outside the employer-employee relationship, an entirely different set of problems arises. The convenience of the payroll tax withholding system is replaced by the difficulties of assessing a wage tax where there is no payroll. Yet, the principal reason for development of the SECA tax was extension of Social Security coverage, not Social Security taxation.

The question of how best to collect a particular source of tax revenue is probably best analyzed from a categorical perspective, that is, how a particular tax rate or type of tax is best applied to a particular category of income. SECA taxes, if considered solely from the revenue-collection perspective, could be simply and effectively assessed on all income flowing from pass-through entities and sole proprietorships, without regard to issues of characterization beyond the general issue of ordinary income as differentiated from capital gains and losses, something the income tax system may not do well, but at least is equipped to handle. Benefit accrual, on the other hand, is a question of individual personal characteristics and work history, regardless of any business or tax category into

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134 See Orloff, supra note 35; see also Dilley, supra note 133.
136 See I.R.C. §§ 1001(a), (b), (c); 1202; 1211; 1212(b); 1222; 1235. But see Snyder, supra note 79.
which the worker might fit.\(^{137}\) Since benefits are supposed to be based on service, not income, the accrual structure should have little to do with issues that typically arise in the calculation of NESE, such as balancing business losses against business income to arrive at a net income figure that in reality has little to do with actual earnings or work effort of the individual.

Thus, one inherent problem of the current SECA tax structure is that, since it is required to fulfill this dual function, the undifferentiated income flowing to individuals—whether from an individual’s solo business activity or an interest in a limited partnership—must be recharacterized to fit into either the wages or non-wages category, so that quarters of coverage may be earned, and SECA taxes paid. Therefore, one way to begin to untangle this web might be to consider a separation of the benefit accrual functions of the SECA tax from its revenue collection functions—a different type of tax, such as an income surtax, for self-employed persons, might be a better approach, at least from a strictly revenue-raising perspective.

2. Dual Character – Income Tax and Wage Tax

A similar duality exists when the SECA tax is compared as a tax to its model, the FICA payroll tax. The FICA tax, as discussed above, was developed as a wage tax for a variety of reasons, involving questions of both principle and administrative convenience, at a time when the income tax was not yet a middle-class tax. While the changing nature of work and the ability of highly paid executives to receive their compensation in forms that are more difficult for the FICA system to reach are putting pressure on the true mandatory and inclusive nature of the tax,\(^{138}\) for most standard employer-employee situations the FICA withholding tax system still works pretty much as originally intended. In fact, there may be some reason to think that the wage tax is so symbiotically linked to the income tax withholding system that the latter might have trouble existing without the former.

The framework upon which the FICA tax is built, however, is a set of assumptions imbedded in the tax structure itself about what is actually occurring when an employer pays money or property to an employee who is performing or has performed or promises to perform services. That property or money is deemed to be wages—paid in exchange for the services—even if the employer and employee in question attempt to characterize it as something else.\(^{139}\) Thus, there is nothing intrinsic about the nature of wage income, as opposed to any other type of income—income is tagged as wages by virtue of its exchange between employer and employee (directly or indirectly).

The SECA tax, however, has never been a wage tax. Even on its face it is an


\(^{138}\)See Halperin, supra note 68.

\(^{139}\)See I.R.C. § 83; see also Alves v. Commissioner, 734 F.2d 478 (9th Cir. 1984).
income tax, assessed on income net of expenses, just as the income tax is assessed for persons with Schedule C trade or business income. An income tax approach is necessary, because there is no possibility of the type of exchange that transforms income for employees into wages because the income is transferred from the employer. However, the self-contained nature of self-employment income creates far more opportunities for manipulation than employee wage income does.

For example, the ability to reduce or eliminate NESE by ordinary business expenses or other business losses has no equivalent in the FICA tax system, under which wages are taxed from the first dollar, even though an employee's overall income may be reduced for income tax purposes for various personal and business expenses.\(^\text{140}\) Thus, because of the very nature of the SECA tax as an income tax, it is immediately out of parallel with the payroll tax system, both in terms of earnings records established for benefit purposes and taxes collected for revenue purposes.

Moreover, the employee typically has little or no control over how her salary is to be paid, on what schedule she will receive it, and how much is to be withheld for payroll and income tax purposes. In contrast, the self-employed person potentially controls both the amount and the timing of income receipt, and therefore of SECA taxes paid. As a result, the self-employed person has greater potential for understatement of SECA income and underpayment of SECA taxes. As long as the Social Security benefits tied to the SECA tax payments were seen as valuable, this was not a substantial problem, as witnessed by the rules enacted in the 1970s to limit the ability of investment partners to transform their investment returns into trade or business income for SECA purposes in order to build up benefit coverage.

Now, however, the opposite incentive is driving the debate, and the SECA structure appears to have few safeguards against the underpayment possibilities. Moreover, the current proposals for revising the treatment of members of pass-through entities under SECA would in most cases remove the presumption that distributable shares are SECA wage equivalents, thus further distorting the differences between employees and the self-employed. Again, the complete solution to this distortion may be to abandon the wage tax model for self-employed persons, and substitute an income surtax to fulfill the revenue collection functions, and some sort of deemed earnings credit system for earnings record and benefit calculation purposes.

C. Defining the Base

Another possible angle to take on the problems of the SECA tax is to consider the question primarily as one of properly (or most easily) defining the SECA tax base. The inherent difficulties of using an income tax to perform a wage tax

\(^{140}\) See Pechman, supra note 4, at 65. (describing the mechanisms of the personal income tax and deductions).
function are clearest where considering how to define the wage portion of the self-employed person's total income. The threshold question is how should the totality of a self-employed person's income be treated—that is, can we separate investment income from trade or business income? Then, can we determine how much of trade or business income is derived from labor as opposed to equity? As suggested above, there seem to be two possible ways of defining the SECA base—one exclusionary and the other inclusionary—and both are necessarily based on assumptions about the context in which SECA income is received by individuals.

The current approach of the SECA tax, with respect to both self-employed sole proprietors, and members of pass-through entities such as partnerships and S corporations, seems to be an inclusionary approach, with some limitations. Under this approach, income is presumed to be NESE unless it is identifiable as a return on capital, that is, either dividends or income analogous to dividends. Certainly for sole proprietors or persons with Schedule C trade or business income generally, the presumption of SECA is that all such income is the equivalent of wages and is taxable under SECA. For general partners in either general or limited partnerships, the same treatment generally applies—all distributive shares of partnership income are included in NESE, so long as the partnership is engaged in the conduct of a trade or business. Although limited partners are not subject to SECA taxes on their distributive shares, unless they are receiving payments for services performed for the partnership, still the inclusionary principle can be said to apply to most self-employed persons.

As was noted above, the assumption underlying even an inclusive and expansive notion of the SECA tax base is that certain categories of persons behave in certain ways with respect to the business entity. Thus, limited partners are considered by definition to be passive investors and therefore their partnership income cannot be considered to be equivalent to wages appropriate for SECA taxation. Apart from limited partners, however, the presumption of current law is that the income from a self-employed person's business activity is essentially equivalent to wages, even though a certain portion of that income could well be considered a return on that person's equity investment in the business.

The ABA proposal for LLCs and partnerships discussed above is an example of this approach, because net income from all pass-through entities that are treated like partnerships under the Code would be presumed to be subject to SECA unless one of the safe harbors for return on capital were applicable, resulting in exclusion of that part of total income from NESE.\(^4\) The 1969 Treasury proposal concerning distributive shares of S corporation income for shareholders is another, more extreme example of an inclusive approach to the SECA tax base, in contrast to the current provisions for S corporation shareholders who do not perform services for the business.

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\(^4\) See ABA Tax Section Letter, supra note 122.

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An alternative approach would be exclusionary; all income would presumptively be viewed as return on investment capital except for that which could be clearly associated with the performance of services. This is essentially the approach of current law as applied to S corporation shareholders. At least one commentator would extend this exclusionary approach to all types of flow-through entities, thus greatly expanding the treatment of partner and LLC income as return on capital:

[i]n general, a rebuttable presumption in favor of investor status for all owners of interests in flowthrough entities would be established. Further, a “material participation” standard would serve as a minimum threshold that, once met, would trigger “reasonable compensation” rules for determination of what portion of an individual’s distributive share of the entity’s income would be treated as remuneration for services subject to the self-employment tax.\(^4\)

One major difference between these two approaches is the degree of administrative resources necessary to enforce proper imposition of the SECA tax under each set of assumptions. For example, the current law’s inclusionary approach is enforced largely through organizational assumptions (S corporations are presumed to pay dividends, not earnings, and limited partners are presumed to receive investment returns, not earnings) and otherwise places the onus on the taxpayer to justify exclusion of any portion of his business income as return on capital. The Service is not required to make a facts and circumstances analysis in most SECA tax cases, except where there is a form over substance argument, as in the cases discussed above in connection with business ventures not formally organized as partnerships.

However, under the ABA proposal, despite its basic inclusionary approach, it seems likely that heightened Service scrutiny of taxpayer arrangements would be required. This is because the safe harbor tests for characterizing income as return on capital could be overcome only by an examination of the individual circumstances of each taxpayer’s relationship to the pass-through entity, to determine that a distribution is in fact earnings, rather than investment return.\(^3\)

The exclusionary approach would even more certainly increase the number of facts and circumstances examinations necessary to enforce SECA tax imposition and collection. For example, under the proposed rebuttable presumption test described above, a positive finding by the Service of material participation in LLC or partnership activities would be necessary to trigger SECA tax application. Because the taxpayer has no incentive to report income as earnings subject to SECA taxation, a higher burden than exists under current law would be placed on the Service to collect roughly equivalent tax revenue. This incentive imbalance is in contrast to the material participation rules applicable to partnership losses, which place the burden on the taxpayer to prove his participation in order to receive his desired tax result.

\(^{12}\)Fritz, *supra* note 12, at 861.
\(^{13}\)Id.
Perhaps more importantly, the proposals that have been advanced in the wake of the LLC–SECA debate generally would weaken the principle of mandatory universal coverage under Social Security, despite protests to the contrary, simply by virtue of their underlying presumption of exclusion of most distributive shares from the SECA base. While the presumptions could always be overcome through increased administrative and examination efforts by the Service, such efforts are unlikely to be mounted in light of the furor over the last several years over abusive practices by the Service, that led to legislation greatly restricting its examination and other powers. If the link between benefit accrual and SECA taxation is maintained, any increase in the ability of self-employed persons unilaterally to exempt income from SECA taxation would constitute a breach of the fundamental mandatory tax system, and effectively allow self-employed people to opt out of Social Security.

D. SECA Tax Payor Identification

A third way of looking at the universe of SECA tax problems is from the perspective of identifying the proper person to pay SECA taxes. There are a couple of issues under current law that can be highlighted in this connection. First, there is the problem of identifying the self-employed person as distinguished from the employee—of determining who is the independent contractor, and who is simply an employee whom the employer has characterized as an independent contractor. Second, and related to the question of identifying independent contractors, there is the issue of relying on common law or state law to provide categories that indicate whether a self-employed person, or, alternatively, a passive investor, exists.

The ABA approach for pass-through entities and their members does have the advantage of eliminating the current tax statute’s reliance on state law definitions of limited and general partner in determining who should be considered to be receiving wage equivalents taxable under SECA. Yet, to avoid a facts and circumstances examination for each taxpayer, some form of categorization that can be assumed to convey certain information about the nature of the person’s income (i.e., wages or non-wages) is necessary. Nonetheless, the state law definitions used, particularly in the case of partnerships, seems to create particular problems as the nature of business organizations evolves. The original approach in the 1970s amendments to Section 1402 perhaps relied too heavily on common law concepts of distinctions between limited and general partners.

More generally, state law (both common law and state statute) possibly has served as too much of an unreliable substitute for independent definitions in the tax law, both in distinguishing independent contractors from employees, and in separating passive investors from active participants in a business activity. Sloughing off the tax decision onto non-tax law can have unfortunate consequences in many areas—but, as is often the case in developing tax statutes, using estab-

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144 See ABA Tax Section Letter, supra note 122.
lished definitions with which practitioners are already familiar frequently is the only way to achieve a legislative end, and there is some hope that the law as drafted will have something close to the desired effect. Nonetheless, once again, as is the case in the problem areas discussed above, the glass slipper may simply be the wrong size, and the painful results—lost revenue, weakening of the universal coverage principle, confusion among taxpayers and their advisors, and increased compliance pressure on the Service—may be intolerable.

V. SOME MODEST SUGGESTIONS

A. In General

The principal source of difficulties in formulating and applying the self-employment tax appears to be the necessity to tie coverage of the self-employed under Social Security to a tax system based on wages. Depending on the priority placed on considerations such as administerability, the fairness of tax burdens between the employed and the self-employed, the comprehensiveness of the tax base, and the accuracy of recorded earnings for Social Security benefit purposes, it may be impossible to develop a substitute that does not create as many problems as it solves. The range of possibilities, therefore, extends from the most radical solution—eliminating SECA altogether and substituting a dual system of revenue collection and benefit accrual—down to the most modest—which may be represented by the Treasury Department’s 1997 proposed regulations which have yet to take effect.

B. Break the Payroll Tax Mold for the Self-Employed

The most far-reaching reform would be to abandon the payroll tax model altogether for the self-employed, and separate the benefit accrual and revenue collection functions. Since the taxes collected are not the basis for benefits, but rather simply serve as a system of counters to keep track of earnings for benefit eligibility and calculation purposes, there is no technical reason to keep those functions combined. However, this kind of radical revision in the current structure would require creation of a Social Security revenue collection system operating as a part of the income tax system, as well as a new basis for calculating earnings equivalents for self-employed people to serve as the basis for benefit eligibility.

With respect to the revenue raising function, some form of income surtax to collect a payroll tax equivalent amount from the self-employed, including all members of pass-through entities regardless of their function in the business of the entity, might be a logical candidate as a substitute for SECA. Such a surtax could be applied to all taxpayers indicating on their regular tax returns expenses and income from a trade or business or a partnership, on the grounds that all such persons have self-employment income to one extent or another. The percentage of the tax could be adjusted to take account of those who have already paid the non-HI portion of the payroll tax, up to the wage and contribution base level, through other employment. Obviously, many details would have to be
explored and filled out, but this type of approach may be worth considering, as it would eliminate the need to determine actual activities of individual members of partnerships or LLCs, for example, and would be focused solely on reported income through the income tax reporting structure.

Benefit accrual under Social Security, and eligibility for Medicare, is probably a more difficult issue, given the need to determine quarters of covered employment on which to base initial eligibility and, probably more importantly, the levels of earnings below the wage and contribution base each year to plug into the indexing and benefit formula calculations at the time the individual becomes eligible for benefits. Nonetheless, some type of accounting for actual earnings might be devised through a deeming approach, based on equating certain levels of the income surtax to certain levels of earnings for benefit purposes. If the income surtax were to be collected directly through the income tax system, regardless of what characterization the taxpayer chooses to apply to her activities, the burden might then be shifted to the taxpayer to insure that she gets earnings record credit, at least for amounts that do actually represent earnings rather than investment dividends.

C. Change Medicare Financing

Since it is unlikely that the payroll tax model will be rejected outright, an alternative, possibly no less bold, would be to look outside the SECA tax structure completely for at least a partial resolution. As noted above, taxpayers had few complaints about the structure and application of the SECA tax until the wage base was eliminated for the Medicare portion of the tax. One partial solution, therefore, might be to eliminate payroll tax financing for Medicare altogether, and finance it completely out of income tax revenue. Since the benefits under the system are not tied to the level of wages, and since virtually all workers now qualify for Medicare coverage in any event, the link between wages and the health insurance program seems more tenuous than ever.

This proposal would do nothing to clarify the proper imposition of SECA taxes on participants in pass-through entities such as partnerships or LLCs, nor would it eliminate controversies about separating earnings from other types of income for SECA tax purposes. However, it would eliminate much of the negative reaction from those partners and members of LLCs most dramatically affected by the elimination of the wage base in 1993, and presumably much of the need for SECA tax reform, at least from their perspective.

Of course, general revenue financing of Medicare would constitute a major break with the earned entitlement concept that has underwritten the program's political support from its inception in the 1960s. Nonetheless, it may be time to reconsider the necessity for precise links between earnings histories and Medicare eligibility in any event, given that Medicare coverage is virtually universal today. A review of eligibility data might be in order, to determine the actual number of persons who acquire Medicare eligibility solely through self-employment earnings, to assess the importance of the SECA Medicare tax system in establishing eligibility for Medicare to start with.
D. Change the Focus from Employment Category to Income Category

Of course, neither of these suggestions is likely to make much headway in the legislative process, and they are suggested more as indicators of the magnitude of the problem of revamping the SECA tax than in the hope that they might be taken up as genuine legislative proposals. Yet the more limited proposals that have been suggested, by the ABA and others, are much less likely to resolve the issue of an ill-fitting statutory model that has created the SECA tax controversy than abandoning the payroll tax concept either in the self-employment or the Medicare context.

For example, the ABA proposals, which the AICPA has endorsed, focus (as described above) on abandoning the presumption of current law that the individual's formal relationship to the entity—i.e., limited or general partner—can be used to identify whether income distributed from the entity to that person constitutes investment return or wage income. Instead, the ABA suggests that the law focus on identifying the type of income itself, and on exclusion of return on capital from the reach of the SECA tax. Such a change in focus is probably an improvement on current law, in that it reduces the reliance of the tax system on categories and definitions established under non-tax law (limited versus general partner), and zeroes in on the fundamental dilemma of the SECA tax—identifying wages in a non-wage economic structure.

However, the ABA proposal places the burden of demonstrating which income is from capital and which is from services squarely on the Service, requiring not only regulations that would properly identify categories of income that would be considered income from capital, but also heightened scrutiny of partnership and LLC member and entity tax returns to detect manipulation of individual income flows and partnership activities that may be improperly recharacterizing income to avoid SECA taxation. While the goal of the ABA proposal is consistent with sound tax and Social Security benefit policy, it retains the negative incentives of current law and could result in substantial revenue loss to the Social Security system. Nonetheless, it represents an improvement on the categorical approach of current law and even of the Treasury Department's 1997 proposed regulations.

E. 1997 Proposed Regulations

The ABA-AICPA proposals were developed in reaction to the proposed regulations issued by the Treasury Department in 1997, which Congress prevented from going final by placing a moratorium on final promulgation in the summer of 1997. These regulations, as discussed above, are not so much a departure from the current law approach (as the ABA proposal would be) as a refinement of the current law's reliance on non-tax categorical assumptions about the role of limited and general partners. The Treasury Department's proposal, importantly, adds the possibility that one participant can possess different types of interests in a pass-through entity, thus receiving both investment return and wage-like income which should be treated differently for SECA tax purposes.
REFLECTIONS ON THE SELF-EMPLOYMENT TAX

The shortcomings of the Treasury Department's approach are essentially the same as the problems inherent in current law. The continued reliance on state law definitions in most circumstances, coupled with disregard of state law identification of limited partnerships in the case of service partnerships, traps these proposals in a continued referential and categorical structure that may have no relationship to the actual character of income to specific members of specific pass-through entities.

VI. CONCLUSION: NEW SHOES FOR OLD

Most of the problems presented by the SECA tax are the consequences of the dual functions served by the self-employment tax system—revenue collection for the Social Security system and benefit accrual measurement under that system. These roles are all a product of attempting to apply concepts developed in connection with the payroll tax to a non-wage purely income tax to which those concepts do not apply.

What is notable about the SECA tax is its peculiarly referential and highly artificial nature. The SECA tax is perhaps more than normally referential, because its imposition depends on common law definitions of terms such as employee, partner, and partnership that are not stated in the Internal Revenue Code, and thus are out of the control of Congress and the Service. It is particularly artificial because it imposes on individuals working outside of the employer-employee relationship a dual role of employer and employee, to fit those individuals into the framework established by the FICA tax, centering on employer-provided wages and conditions of service controlled by someone other than the worker.

The current conceptual framework of SECA requires the tax system and taxpayers to create distinctions between wages and return on capital out of inherently undifferentiated income, not for tax purposes, but rather for Social Security benefit purposes. Moreover, the need to use net income from self employment as a measure of wages means that self-employed persons have an inherent advantage, in terms of manipulation of income to avoid SECA tax liability, over employed persons.

Any revision to the SECA tax attempting to resolve the current issues concerning LLCs and other pass-through entities must, for the sake of administerability, involve application of categories and assumptions about the nature of the relationship of persons in those categories to the business entity at issue. The ABA proposals, focused on proper characterization of income, as opposed to characterization of individual roles within the context of a pass-through business entity, probably come as close as possible to maintaining the current difficult link between the SECA tax system and the Social Security benefit system, while still allowing for some leeway in interpretation, and maintaining (more or less) the integrity of the concept of universal mandatory coverage.

Nonetheless, the preferable solution would be to break the link completely, and abandon the attempt to characterize some income as wages primarily to
realize the non-tax goal of benefit accrual under Social Security. Of course, the questions raised by such a proposition about the use of the payroll tax model as the revenue source for Social Security benefits can also, to some extent, be raised about payroll taxes generally. That discussion, however, is for another article. In the self-employment context, at least, it should be possible to construct a deemed earnings credit system that fairly reflects a self-employed worker's actual earnings experience, while imposing a completely separate income surtax that would raise at least the approximately equivalent amount of revenue. While such a dual system might be less precise than the FICA tax system attempts to be in recording earnings and imposing taxes, it would probably be about as accurate as the current SECA tax system, given the ability of self-employed taxpayers to manipulate the net income measure.

The primary point is that the tax system generally relies on categories and assumptions that enable us to make distinctions between types of income, and apply different rates of taxation to those types of income. Thus, a separation of benefit accrual from revenue-raising should be possible to accomplish, simply by using the appropriate assumptions and categories in a way that reduces taxpayer ability to manipulate definitions and income flows to eliminate their own taxes and in effect create optional coverage under Social Security. A dual system—one for benefit accrual, and the other for revenue collection—is consistent with Social Security’s underlying principles and would result in less distortion of the tax system. Sometimes making a new shoe—or, in this case, two new shoes—is easier than trying to make an old one fit.