

# CBO

## The Taxation of Capital and Labor Through the Self-Employment Tax

**SCHEDULE SE  
(Form 1040)**  
Department of the Treasury  
Internal Revenue Service

**Self-Employment Tax**

OMB No. 1545-0044  
**2004**  
Attachment  
Sequence No. 17

▶ Attach to Form 1040. ▶ See Instructions for Schedule SE (Form 1040).

Name of person with self-employment income (as shown on Form 1040) \_\_\_\_\_  
Social security number of person with self-employment income ▶ \_\_\_\_\_

### Who Must File Schedule SE

You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

**Note.** Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

**Exception.** If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 57.

### May I Use Short Schedule SE or Must I Use Long Schedule SE?

Did You Receive Wages or Tips in 2004?

**No** → Are you a minister, member of a religious order, or Christian Science practitioner who received IRS approval **not** to be taxed on earnings from these sources, **but** you owe self-employment tax on other earnings?  
No → Are you using one of the optional methods to figure your net earnings (see page SE-3)?  
No → Do you receive church employee income reported on Form 1040 of \$108.28 or more?  
No → **You May Use Short Schedule SE Below**

**Yes** → Was the total of your wages and tips subject to social security or railroad retirement tax **plus** your net earnings from self-employment more than \$87,900?  
Yes → **You Must Use Long Schedule SE on**  
No → Did you receive tips subject to social security or Medicare tax that you **did not** report to your employer?  
Yes → **You Must Use Long Schedule SE on**  
No → **You May Use Short Schedule SE Below**

Form profit or (loss) from \_\_\_\_\_  
box 14

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## **Note**

Numbers in the text and tables may not add up to totals because of rounding.

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## Summary

**S**ince 1950, self-employed individuals have been covered by the Social Security system. In many regards, their obligation to pay Self-Employment Contributions Act (SECA) taxes into the Old-Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (HI) trust funds and their entitlement to Social Security and Medicare benefits parallel those of workers who are not self-employed and who thus are covered under the Federal Insurance Contributions Act (FICA). In both cases, the OASDI tax base is limited to income below a certain threshold, and the HI tax base is not constrained by any income ceiling. The two systems, however, diverge in an important way: The FICA tax is based solely on income from labor, but the SECA tax is based on net business income, which can also include income from capital. Such a difference in the tax code (say, among businesses providing the same goods and services) can prompt people to make choices that they would not otherwise make about self-employment or the organizational form of a business, thereby reducing the efficient allocation of resources.

For this analysis, the Congressional Budget Office (CBO) decomposed the SECA tax bases for HI and OASDI into their labor and capital components, but the discussion focuses on the HI tax base because it is unconstrained by the income ceiling of the OASDI tax. CBO estimates that approximately 40 percent of the SECA-HI tax base (the amount of self-employment income subject to the HI tax) derives from capital, and the remainder derives from labor. Furthermore, more than half of the labor income of self-employed people—that is, the portion of their business income that would be subject to the FICA-HI tax if the business was incorporated instead of being a sole proprietorship or a partnership—is not included in the SECA-HI tax base. That occurs because when net income from all of a taxpayer's businesses is less than the labor income from those businesses, the excess

labor income is excluded from the SECA tax base. There is no similar exclusion from the FICA tax base. With both the taxed capital income and the excluded labor income accounted for, the total SECA-HI tax base is roughly three-quarters of the amount of income that would be taxable under the FICA-HI rules.

Lawmakers could change the SECA tax base to try to align it more closely with the rules governing the FICA tax base. CBO analyzed three options for alignment that would modify the SECA tax base by either reducing the share of capital income or increasing the share of labor income included in that base. No option by itself would accomplish both of those objectives when applied to both sole proprietorships and partnerships, but one option would do so if applied only to partnerships. Two of the options would reduce the size of the SECA tax base—in one case by more than half—whereas the third option would increase the SECA tax base by a little.

### Entities Subject to the SECA Tax

The SECA tax base has not been changed by statute since the Social Security Amendments of 1977. Those amendments, governing Social Security and Medicare, envisioned three types of entities whose owners would be subject to the SECA tax:

- *Sole proprietorships*, whose owners are required to include all of their business earnings in the SECA tax base.
- *General partnerships*, in which each partner is fully liable for the debts of the business. Partners must include their share of the partnership's earnings in the SECA tax base along with any guaranteed payments they receive in exchange for the services they provide.

- *Limited partnerships*, in which one or more general partners are fully liable for the debts of the business and the limited partners are liable only up to the amount of their investment. Limited partners face SECA tax only on their guaranteed payments.

Since 1977, new types of business entities—most notably, limited liability companies (LLCs) and limited liability partnerships (LLPs)—have emerged. Such entities have no equivalent to general partners: Except in a few cases, all members are liable for the company’s debts only up to the amount they invested. The SECA tax obligations of LLC members and limited liability partners are less straightforward than those of general and limited partners.

### Labor and Capital Income Under Current Law

For owners of corporations, the amount of labor income subject to the FICA tax must represent “reasonable compensation”; in other words, it should bear some resemblance to the market wage for their services. In this analysis, CBO estimated the labor income for self-employed workers using an assessment of their reasonable compensation. All other positive net income was attributed to capital. In 2001 and 2004, labor income accounted for 58 percent of the SECA-HI tax base and almost 75 percent of the SECA-OASDI tax base, CBO estimates. (For this report, CBO examined the SECA tax base in 2001 and 2004.<sup>1</sup> The discussion focuses on the more recent data, referring to the earlier year only when the results differ substantially.)

Overall, more than half (65 percent) of the capital income of unincorporated businesses was included in the SECA-HI tax base in 2004, but less than half (44 percent) of the labor income was included (see Summary Figure 1). In contrast, if all self-employed people had worked for others and paid FICA taxes, none of their

capital income—and all of their labor income—would have been included in the HI tax base. Because of the income ceiling for OASDI, only 26 percent of the capital income of unincorporated businesses was included in the SECA-OASDI tax base in 2004.

### The Taxation of Labor and Capital Income Under Alternative Options

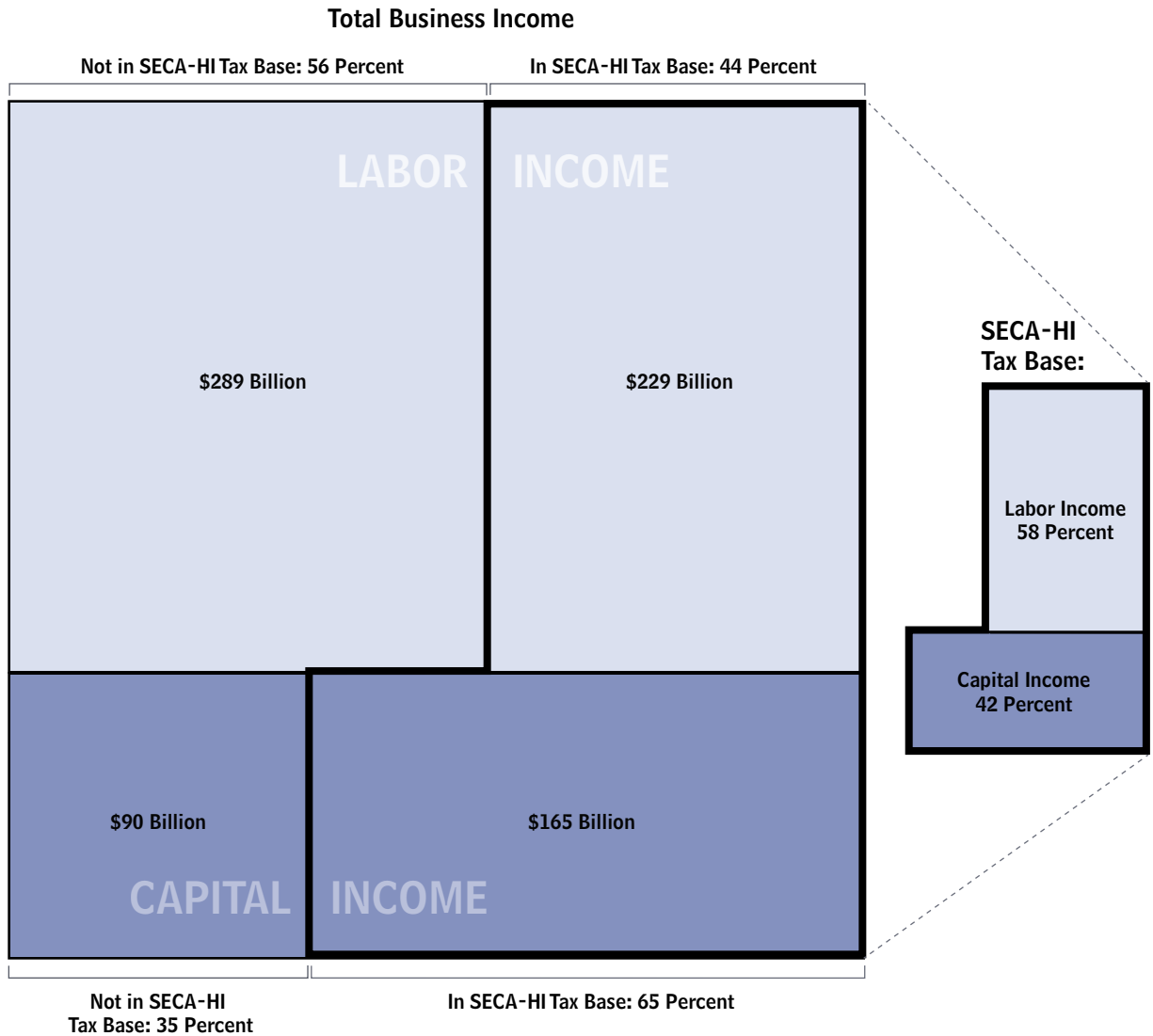
CBO examined three policy options that would alter the structure of the SECA tax:

- A *material participation standard* would change the criteria for determining which partners must pay SECA taxes on their share of business income and extend those criteria to LLC members. Such a standard would clarify much of the ambiguity surrounding the SECA tax but, on balance, would subject more income from capital to the self-employment tax.
- A *reasonable compensation standard* for identifying labor income and including it in the SECA tax base would exclude capital income from the SECA tax base by definition and require all labor income to be included. If the option was limited to partnerships (including multimember LLCs), it would, on average, increase the included share of labor income. If sole proprietorships were included, however, the opportunity to mischaracterize labor income as capital income (a choice not available under current law) would probably reduce the included share of labor income.
- A *safe harbor for a return on capital* would provide taxpayers with a formula that used their tangible assets to calculate how much capital income should be excluded from the SECA tax base. The policy that CBO examined would shelter a relatively small share of capital income, probably reflecting the importance of intangible capital (such as patents, trademarks, and intellectual property) in generating income for unincorporated businesses. Furthermore, such a policy would reduce the included share of labor income in cases where the return on capital was less than the safe-harbor amount.

1. The data necessary to conduct the analysis in this report are generally not available until three years after the tax year ends. The data from 2004 were the most recent available when CBO began its analysis of the SECA tax base.

**Summary Figure 1.**

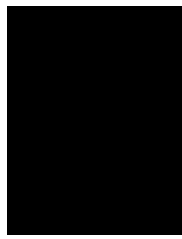
**Labor and Capital Shares of the Business Income of Profitable Sole Proprietorships and Partnerships Included or Not Included in the SECA-HI Tax Base, 2004**



Source: Congressional Budget Office.

Notes: The SECA tax base excludes \$24 billion for which an entity type could not be identified.

SECA = Self-Employment Contributions Act; HI = Hospital Insurance (Medicare Part A).



# The Taxation of Capital and Labor Through the Self-Employment Tax

## Background on Social Security and Medicare Taxes

Social Security and Medicare Part A (which covers inpatient services provided by hospitals and certain other care) are largely financed by taxes on the earnings of employees and self-employed workers. Currently, employers and employees covered under the Federal Insurance Contributions Act (FICA) each contribute 6.2 percent of an employee's annual earnings—up to a ceiling—to the Old-Age, Survivors, and Disability Insurance (OASDI) trust fund, which supports the Social Security program.<sup>1</sup> That ceiling, which is set at \$110,100 in 2012, is adjusted for average wage growth. Social Security benefits for retired workers, their survivors, and disabled workers are based on workers' earnings histories. Wage earners and their employers also each contribute 1.45 percent of earnings to the Hospital Insurance (HI) trust fund, which supports Medicare Part A. There is no ceiling on earnings subject to the HI tax.<sup>2</sup>

When it was established in 1937, the Social Security system made no provision for self-employed workers: They did not contribute to the system, nor were they eligible to collect benefits based on their self-employment income. Beginning in 1950, however, Social Security coverage was extended to some self-employed workers, who began to make contributions under the Self-Employment

Contributions Act (SECA). Subsequent amendments to the Social Security Act gradually expanded coverage for self-employed individuals. After the creation of Medicare in 1965, the SECA tax increased to include contributions to the HI program. By 1983, the SECA tax rate (both the OASDI and HI portions) was equal to the combined FICA rates that applied to wage earners and their employers. To maintain the parallelism with wage earners, whose employers can deduct their share of FICA taxes, self-employed workers were allowed to deduct half of their contributions (after making certain adjustments) from their income taxes.

When the SECA tax was enacted in 1950, FICA taxes were just over 5 percent of federal revenues. By 2011, more than 30 percent of federal revenues came from FICA taxes. SECA taxes are a much smaller share, making up just 2 percent of federal revenues in 2011. The ratio of SECA tax revenues to FICA tax revenues closely reflects the ratio of self-employed people to wage earners.

## How the FICA and SECA Tax Bases Differ

A tax's "base" is the measure—for example, income or property—that is subject to the tax. The FICA tax base includes the wages of employees, and the SECA tax base is the net business income (that is, receipts minus expenses) of self-employed workers. The FICA tax base is limited to labor income, but the SECA base can include some capital income. Although the intent of the Congress was to tax the self-employed "on remuneration received for one's own labor," the tax base that was enacted did not conform to that intent.<sup>3</sup>

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1. The rate of OASDI tax paid by employees was reduced by 2 percentage points for calendar years 2011 and 2012.

2. Beginning in 2013, the Affordable Care Act (comprising Public Law 111-148 and the health care provisions of Public Law 111-152) increases the total HI tax to 3.8 percent on earnings in excess of \$200,000 for unmarried people, on combined earnings in excess of \$250,000 for married couples filing joint returns, and on earnings in excess of \$125,000 for married individuals filing separate returns.

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3. See Patricia E. Dille, "Breaking the Glass Slipper—Reflections on the Self-Employment Tax," *The Tax Lawyer*, vol. 54, no. 1 (Fall 2000), p. 74. That article cites the quotation from Senate Report No. 81-1669 (1950), which accompanied the Social Security Amendments of 1950.

Specifically, the SECA tax base can include the return on investments in tangible and intangible (but not financial) assets made by an unincorporated business. In contrast, if an incorporated business makes the same investment, the return is reflected in the company's profits, not in its employees' wages, and therefore is not included in the FICA tax base. Another difference is that when a person's labor income exceeds net business income across all businesses (or portions thereof) owned by that person, the excess labor income is excluded from the SECA tax base. In contrast, for an incorporated business, profitability has no effect on the FICA tax liability of its owners.

Those differences can affect an individual's decision about whether to be self-employed or to work for somebody else. It can also influence the choice of how to organize a firm: A business owner's capital income (and losses) will be taxed differently under the Social Security Act depending on whether the business incorporates. In both cases, the tax code can prompt people to make choices that they would not otherwise make, thereby reducing the efficient allocation of resources.

Both tax bases exclude a portion of labor income, but the FICA and SECA tax bases differ in the types of labor income that they exclude. Although the FICA tax base excludes employer-provided health insurance (a form of labor income), self-employed individuals generally cannot deduct from the SECA tax base the cost of the health insurance they purchase for themselves.<sup>4</sup> Also, partners whose liability for a partnership's debts is limited to the amount they invested are not required to pay SECA taxes, regardless of how much labor they contribute, unless they receive "guaranteed payments" (that is, compensation for labor that is to be paid even if the partnership has no net income). In contrast, owners of incorporated businesses—those subject to the corporate income tax (C corporations) and those that pass their profits through to their owners (S corporations)—are required to include "reasonable compensation" for their labor in their FICA tax base (although many owners have an incentive to characterize as much compensation as they can as capital income to avoid that tax).<sup>5</sup>

4. The Small Business Jobs Act of 2010 (P.L. 111-240) allowed self-employed individuals to deduct from the SECA tax base—for 2010 only—the cost of health insurance for themselves as well as their spouse, dependents, and children under age 27. For income tax purposes, they have generally been able to deduct a portion of their health insurance premiums since 1986, and all of them since 2003.

### The Definition of Self-Employment Income

Whether an owner of a small business is considered self-employed, and therefore is subject to the SECA tax, depends on the legal form in which his or her business is organized. The key distinction is between firms that are incorporated and those that are not. Owners of incorporated businesses are never considered self-employed for tax purposes. In contrast, owners of unincorporated businesses are generally considered self-employed.<sup>6</sup> (Members of the clergy are also subject to SECA taxes, even if they are considered church employees for income tax purposes.)

Among unincorporated businesses, a common distinction is between sole proprietorships and partnerships. Most owners are sole proprietors—that is, they own the entire business themselves. All net income from those businesses is considered self-employment income and thus is subject to SECA taxes.

Unincorporated businesses with more than one owner are partnerships. A partnership reports its profits to the Internal Revenue Service (IRS) using Form 1065, but no income or SECA taxes are assessed at the partnership level. Instead, the partnership's business and investment income are allocated, or "passed through," to the partners. If a partner is an individual, pass-through income is taxed under the individual income tax in the same way as

5. The Treasury's regulations defining reasonable compensation include the following: "It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances" (see [www.taxalmanac.org/index.php/Treasury\\_Regulations,\\_Subchapter\\_A,\\_Sec.\\_1.162-7](http://www.taxalmanac.org/index.php/Treasury_Regulations,_Subchapter_A,_Sec._1.162-7)). That amount is not necessarily the market wage one would have to pay an employee, whose circumstances differ from an owner's. Some people argue that business owners realize nonmonetary labor income from "being their own boss," even after considering the extra stress that self-employment can entail, and that an employee would demand comparable compensation in monetary form. See, for example, Barton H. Hamilton, "Does Entrepreneurship Pay? An Empirical Analysis of the Returns to Self-Employment," *Journal of Political Economy*, vol. 108, no. 3 (June 2000), pp. 604–631.

6. Since 1997, most unincorporated businesses have had the rarely exercised option of being taxed as corporations. If that option is exercised, the business is subject to an entity-level corporate tax, and its owners are not considered self-employed. Also, because most publicly traded partnerships are required to be taxed as corporations, their partners are not considered self-employed.



**Table 1.**  
**Income Subject to SECA Tax**

Type of Ownership Interest	Income Subject to Tax
Sole Proprietor	Net business income
General Partner <sup>a</sup>	Guaranteed payments and share of net business income <sup>b</sup>
Limited Partner <sup>c</sup>	Guaranteed payments

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act.

- a. Includes partners in limited liability partnerships and members of limited liability companies whose interest in the firm is not basically of an investment nature.
- b. A share of rental income is also included if the partner is engaged in the sale of real estate. A share of portfolio income is included if the partner is engaged in the sale of securities.
- c. Includes partners in limited liability partnerships and members of limited liability companies whose interest in the firm is basically of an investment nature.

income from other sources. In some cases, the partner may be a corporation, in which case pass-through income is subject to the corporate income tax. Pass-through income (as well as certain deductions and credits) is divided into various items that are handled differently on the receiving partner's tax return. Three of those items are potentially included in the SECA tax base:

- Guaranteed payments received as compensation for services provided by the partner;
- The partner's proportional share of the partnership's net business income (from which all guaranteed payments have been deducted); and
- The partner's proportional share of rental and portfolio income (but only if it is received in the course of business as a dealer in real estate or securities).<sup>7</sup>

7. A partner's "proportional" share generally refers to allocations based on his or her ownership share in the business. However, partnerships are free to allocate income among partners in any way they find mutually agreeable. In this report, the term "proportional share" covers all such allocations, whether or not they are actually proportional to anything. The term is synonymous with "distributive share"—the phrase used in the Internal Revenue Code even though it covers allocations that are retained by a firm rather than distributed.

The tax code recognizes two different kinds of partners for purposes of calculating SECA taxes. *General partners*, who are fully liable for the debts of the partnership, must include all three of the above items in their tax base. In contrast, *limited partners*, who assume liability up to the amount of their investment, must include only guaranteed payments for services (see Table 1).

Some self-employed people own all or part of more than one business. If so, they can use the losses of one or more of their unincorporated businesses to offset the gains from their other unincorporated businesses. Business losses cannot, however, reduce the SECA tax base below zero, nor can they be carried over to other tax years (as they can be for income tax purposes). If net self-employment income is less than \$400 in a given year, no SECA tax is due.

### Defining the Roles of Partners

SECA tax liabilities depend not only on whether a taxpayer is a sole proprietor or a partner, but also, if a partner, on whether the taxpayer is a general or limited partner. The distinction between general and limited partners was introduced by the Social Security Amendments of 1977. Before then, all partners were treated as general partners are today. However, it is state laws—not the Social Security statutes or other federal laws—that define the difference between general and limited partners. State laws also recognize other types of business entities that may be treated as partnerships for federal income tax purposes, but those laws do not address whether the owners of such entities should be classified as general or limited partners for SECA purposes. Thus, changes in state laws regarding businesses' organization have resulted in some confusion over the appropriate classification of partners' income under SECA.

Although the role of general partners has not changed, the legal concept of the limited partner has evolved over time. Since 1916, states have generally tried to maintain uniformity by adopting the Uniform Limited Partnership Act (ULPA), a model statute proposed by the National Conference of Commissioners on Uniform State Laws. The purpose of limited partnerships was to facilitate passive investing in a noncorporate environment. Hence, until 1985, ULPA did not permit limited partners to participate in control of a business—that role was reserved for general partners. The 1985 version of ULPA allowed limited partners to participate in certain management activities, and the 2001 version removed virtually all

restrictions on the management activities of limited partners.<sup>8</sup> In the states that adopted that version, the primary distinction between general and limited partners (other than the liability aspect) is that only general partners can enter into binding contracts on behalf of the entire partnership.<sup>9</sup>

The creation of new types of entities, such as limited liability partnerships (LLPs), was not anticipated in the Social Security Amendments of 1977, upon which current law regarding the SECA tax base rests. In an LLP, no partner can be held liable for another partner's fraud or negligence. Even though the liability shield is broad—partners are shielded from the partnership's liabilities as if it were a corporation—some states' LLP statutes provide that a partner is not shielded from liability for his or her own actions. Most LLPs are found in the professional services industry (which includes, for example, medical, law, and accounting firms). The tax treatment of such partners is not explicitly addressed in Social Security laws. However, if a general partnership converted to an LLP, the partners previously classified as general partners would retain the corresponding SECA tax treatment even after the conversion. In 2011, the U.S. Tax Court ruled that limited liability partners who provide services on behalf of their firm could not be classified as limited partners for SECA tax purposes.<sup>10</sup>

More important than the changing role of limited partners under ULPA or the development of LLPs, however, is the rise of limited liability companies (LLCs)—an organizational form that provides liability protection similar to that of a limited partnership without restricting participation in management or the right to enter into contracts.<sup>11</sup> Although LLCs had been established as early as the late 1970s, not until 1988 did the IRS definitively

rule that LLCs could be taxed as unincorporated businesses rather than as corporations. Under current IRS rulings and regulations, LLCs are taxed as unincorporated businesses unless they specifically request to be treated as corporations, an option that few select. However, because members of multiowner LLCs are not classified under state laws as either general or limited partners—the types recognized in Social Security laws—their SECA tax treatment remains ambiguous.

In 1997, the Department of the Treasury proposed regulations to clarify the definition of limited partners under SECA. The proposed 1997 regulations would have deemed any partner or LLC member to not be a limited partner (making his or her share of the partnership's business income subject to the SECA tax) if the partner met one of the following conditions:

- Personal liability for the debts of the partnership;
- Authorization to enter into binding contracts on behalf of the partnership;
- Contribution of more than a minor amount of labor by a service partner to a service partnership; or
- Contribution of more than 500 hours of labor per year to any other type of partnership.

Although those proposed regulations would have removed some of the ambiguity in the tax treatment of partners, they also would have subjected to SECA taxes more of the income of limited partners (as defined by state law) contributing more than 500 hours of labor. The proposed regulations were never finalized, and the Congress forbade the Treasury from engaging in rule-making on the subject for a short period.<sup>12</sup> Although that prohibition ended in 1998, the Treasury has indicated that it plans to wait for further legislative guidance before issuing new regulations. For many years, most tax practitioners believed they would not be challenged by the IRS if they followed the proposed 1997 regulations with

8. Both the 1916 and 1976 versions of the Uniform Limited Partnership Act were eventually adopted by 49 states. As of July 2012, 18 states and the District of Columbia had adopted the 2001 version. For further updates, see National Conference of Commissioners on Uniform State Laws, "Legislative Fact Sheet—Limited Partnership Act" (no date), <http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act>.

9. American Bar Association, Section of Taxation, "Tax Rules Governing Self-Employment Income of Limited Liability Companies and Partnerships" (May 29, 2002), p. 2, [www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2002/020529c.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2002/020529c.authcheckdam.pdf).

10. *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 7 (2011).

11. Limited liability companies are now more common than general or limited partnerships. In 1994, only 3 percent of partnerships filing Form 1065 (representing 2 percent of partners) were LLCs. Ten years later, 50 percent of partnerships (representing 32 percent of partners) were LLCs. See David Wheeler and Nina Shumofsky, "Partnership Returns, 2004," *SOI Bulletin*, vol. 26, no. 2 (Fall 2006), p. 111.

12. Section 935 of the Taxpayer Relief Act of 1997 (P.L. 105-34).

respect to LLC members.<sup>13</sup> The 2011 Tax Court decision involving an LLP's SECA tax status did not follow those regulations, but it nevertheless gave greater weight to the contribution of labor than to liability exposure. Some tax professionals have warned LLCs that the opinion might apply to them as well.<sup>14</sup>

## Incentives Created by SECA Tax Treatment

The current treatment of partnership income with respect to SECA taxes creates incentives to organize partnerships in ways that minimize tax liabilities—and, more rarely, maximize Social Security benefits. In addition, partners have an incentive to characterize their involvement in a business in ways that would reduce their tax liability. The extent to which labor income and capital income are included in the FICA and SECA tax bases can affect the choice between working for someone else or being self-employed.

### Mischaracterizing Involvement with a Business

Most significantly, people have an incentive to be classified as limited partners, even if they are active in a partnership.<sup>15</sup> The incentive is strongest for those whose combined wages and self-employment income exceed the OASDI ceiling, because income over the ceiling that they earn as general partners would be subject to the HI portion of the SECA tax but would not earn them any additional retirement benefits. The same incentive would apply to guaranteed payments they might earn as a limited partner, which would encourage them, in certain circumstances, to forgo such payments for their labor in favor of a larger proportional share of profits. Because there is no requirement that guaranteed payments represent reasonable compensation, such “SECA-averse” behavior is legal.

At the other extreme (and probably much less common), people with a partnership interest but little or no wages or self-employment income over the course of their career

might become “Social Security seekers.”<sup>16</sup> They would have an incentive to be classified as a general partner, even if they could qualify as a limited partner, because they would receive greater Social Security benefits. Whether a person became a Social Security seeker would depend on whether the accrual of retirement benefits through the Social Security system outweighed the risk of losses and liability inherent in being a general partner. As wages and self-employment income from other sources increased, the incentive to characterize passive partnership income as income subject to the SECA tax would diminish.

### Influencing Employment Decisions

If employment decisions are affected by the tax treatment of labor income and capital income, resources in the economy will probably be allocated inefficiently. For example, a creative person might, solely for tax reasons, choose not to be self-employed and thus would have his or her creativity channeled toward the employer's priorities rather than the person's talents. Alternatively, tax considerations might lead a skilled worker with limited aptitude for independent work to be self-employed. That would divert the worker's attention toward management tasks and away from the best use of his or her abilities.

The current FICA and SECA tax system creates incentives to become self-employed as well as incentives to work for another person. Including capital income in the SECA-HI tax base, for example, discourages self-employment because it increases a person's tax bill without generating any corresponding increase in Medicare benefits.<sup>17</sup> The effect of including capital income in the

13. *Kiplinger Tax Letter*, vol. 78, no. 13 (June 20, 2003).

14. Claire Y. Nash, “Partners’ Limited Liability and Self-Employment Tax,” *The Tax Adviser* (July 1, 2011), [www.aicpa.org/Publications/TaxAdviser/2011/July/Pages/nash\\_jul2011.aspx?action=print](http://www.aicpa.org/Publications/TaxAdviser/2011/July/Pages/nash_jul2011.aspx?action=print).

15. The fact that an individual can have a split interest in a partnership (part as a general partner and part as a limited partner) does not change the incentive. It merely provides a more subtle mechanism for manipulating tax liability.

16. Such behavior has been cited as a reason the Social Security Amendments of 1977 changed the treatment of limited partnership income; see Patricia E. Dilley, “Breaking the Glass Slipper—Reflections on the Self-Employment Tax,” *The Tax Lawyer*, vol. 54, no. 1 (Fall 2000), p. 85.

17. Beginning in 2013, the Affordable Care Act requires taxpayers with adjusted gross income in excess of \$200,000 (\$250,000 for married taxpayers filing joint returns) to pay an “Unearned Income Medicare Contribution”—a tax that explicitly targets capital income such as interest, dividends, and capital gains. Despite its name, the tax is not allocated to the HI trust fund. Nevertheless, it increases the cost of investing in financial securities relative to the cost of investing in tangible business property and thus will probably make self-employment a more attractive option than it is now. Analysis of the effects of that legislation is outside the scope of this report.

**Table 2.**  
**Distribution of the SECA Tax Base, by Type of Entity, 2004**

	Percentage of Tax Base
Sole Proprietors	
Nonfarm	68
Farm	1
Partners in or Members of:	
General partnerships	5
Limited partnerships <sup>a</sup>	2
Limited liability companies	9
Limited liability partnerships	7
Other partnerships	*
Unknown type of partnership	1
Other or Unknown (Including clergy's wages)	6
All Types of Entities	100

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; \* = between zero and 0.5 percent.

a. Includes income from both general partners and limited partners in the limited partnership.

SECA-OASDI tax base is less clear: Although taxing such income results in higher expected Social Security benefits, the increase is not necessarily enough to encourage people to choose to be self-employed.<sup>18</sup> Excluding labor income creates the opposite incentives. In particular, the ability to exclude labor income in excess of the net income of all of a taxpayer's businesses from the SECA-HI tax base makes self-employment more attractive.

### A Snapshot of the SECA Tax Base

In this report, the Congressional Budget Office (CBO) examines the SECA tax base in 2001 and 2004—two very different points in the business cycle. In early 2001, the economy was in a recession, and the unemployment rate rose throughout the year. As a share of national

18. This report adopts the convention of appending either “HI” or “OASDI” to “SECA” or “FICA” whenever the situation or conclusion being discussed applies only to that tax. Whenever references to the FICA or SECA tax bases are not specific to either the OASDI or HI taxes, the usual conventions (that is, simply “FICA” and “SECA”) are used.

income, capital income—defined here as net interest, rental income, and corporate profits—was slightly smaller than average: 17.0 percent, compared with a post-1928 average of 17.7 percent.<sup>19</sup> In 2004, the economy was expanding, and the unemployment rate fell throughout the year. Capital income as a share of national income was slightly higher than average (18.1 percent). Despite those differences, many of the report's findings are similar in both years. For that reason, the discussion focuses on the more recent data, referring to the earlier year only when the results differ substantially. The statistical snapshot in this section is presented for the tax base for the Hospital Insurance program—that is, the SECA-HI tax base, which is unconstrained by the ceiling for the OASDI tax.

### Disaggregating the Tax Base

Between 2001 and 2004, the SECA-HI tax base grew from \$328 billion to \$385 billion.<sup>20</sup> In 2004, most self-employment income was received by sole proprietors—that income (from both farm and nonfarm sources) constituted 69 percent of the SECA-HI tax base (see Table 2). About one-quarter of the tax base consisted of income from partnerships. The remaining 6 percent came from other sources (such as payments to clergy) or could not be linked to a type of entity.

CBO examined the tax bases of partnerships in three ways:

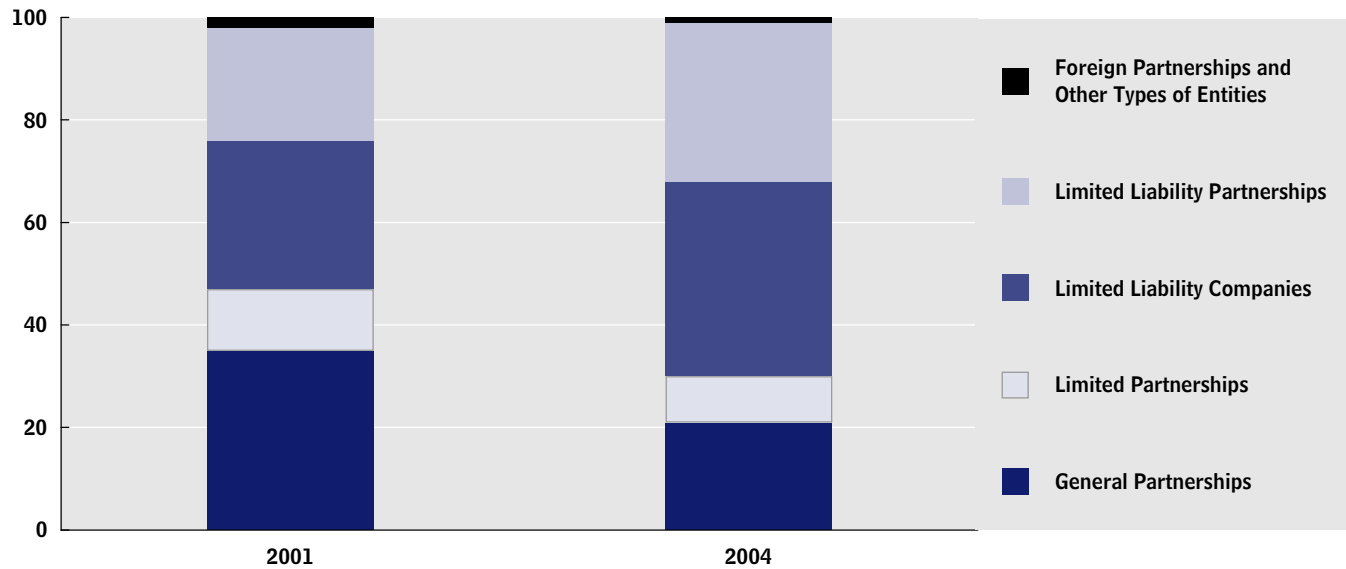
- By entity type—general partnership, limited partnership, LLC, LLP, and other;
- By degree of participation—material and nonmaterial; and
- By type of pass-through item—guaranteed payments and proportional shares of business and rental income.

19. Shares were calculated from Table 1.12, “National Income by Type of Income,” of the national income and product accounts tables produced by the Bureau of Economic Analysis, available at [www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1](http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1).

20. Because of the 7.65 percent exclusion to approximate the deduction for FICA taxes taken by employers, the SECA tax base is less than self-employment income. The latter was \$355 billion in 2001 and \$418 billion in 2004.

**Figure 1.****Distribution of Partnership Income in the SECA Tax Base, by Type of Entity, 2001 and 2004**

(Percent)



Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act.

**Type of Entity.** Although the share of the SECA tax base attributable to partnerships did not change between 2001 and 2004, CBO found that the portion coming from LLCs and LLPs increased noticeably over that period. Of partnership income in the SECA tax base that could be attributed to an entity type in 2001, general partnerships provided the largest share (35 percent); LLCs had 29 percent, followed by LLPs (22 percent) and limited partnerships (12 percent). By 2004, however, LLCs provided the largest share (38 percent), followed by LLPs (31 percent); general partnerships fell to 21 percent and limited partnerships to 9 percent (see Figure 1). Those shifts are consistent with a well-documented trend, at the entity level, of growth in the importance of LLCs.<sup>21</sup> (For net business income, that trend seems to have leveled off after 2004, but it continued at least through 2007 with respect to the number of firms and businesses' receipts.)

**Degree of Participation.** Partnership income can also be disaggregated by partners' degree of participation in their business. Income received by "material participants" (defined primarily in terms of hours worked) is reported

as "nonpassive," whereas income received by "non-material participants" is categorized as "passive." Under current law, the material participation test is used for individual income tax purposes to distinguish between nonpassive losses, which can offset regular income, and passive losses, which can offset only passive income. That test, however, does not apply to the SECA tax base. In 2004, about 90 percent of partnership income in the SECA tax base was classified as nonpassive and the rest was considered passive (see Table 3).

21. Although the changes in shares of the SECA tax base attributable to general partnerships, limited partnerships, and LLCs mirror the changes in income shares at the entity level, the change in the SECA tax base attributable to LLPs is much greater than the corresponding change at the entity level; see Figure 1 in David Wheeler and Nina Shumofsky, "Partnership Returns, 2004," *SOI Bulletin*, vol. 26, no. 2 (Fall 2006), p. 111. Also, the share of the SECA tax base attributable to other or unknown types of entities declined substantially between 2001 and 2004 for unknown reasons. Much of the unexplained increase in the share attributable to LLPs probably reflects the more complete assignment of entity types to individuals in 2004.



**Table 3.**  
**Distribution of Partnership Income in the SECA Tax Base, by Degree of Participation and Pass-Through Item, 2004**

	Percentage of Partnership Income
Degree of Participation	
Material (Or nonpassive)	91
Nonmaterial (Or passive)	9
All Degrees of Participation	100
Pass-Through Item	
Guaranteed payments	21
Proportional share of business income	77
Proportional share of rental income	2
All Identifiable Pass-Through Items	100

Source: Congressional Budget Office.

Note: As specified in section 469 of the Internal Revenue Code, material participation is defined, for income tax purposes, primarily in terms of hours worked. It does not apply for Self-Employment Contributions Act (SECA) purposes.

**Pass-Through Item.** Partnership income can also be disaggregated among the three key pass-through items shown in Table 3. In 2004, more than three-quarters of the partnership income in the SECA tax base was passed through as the partner’s share of business income. Approximately 20 percent was passed through as guaranteed payments, CBO estimates, and the rest was passed through as rental income.

**What Portion of Noncorporate Business Income Is Included in the SECA Tax Base?**

Net noncorporate business income is part of the individual income tax base. Depending on the circumstances, however, only a portion of that income may be included in the SECA tax base. Treatment under those two tax bases may be similar for owners of some types of entities (for example, sole proprietorships and general partnerships) but dissimilar for others (such as limited partnerships). Differences can reflect statutory exclusions from the SECA tax or aggressive interpretations of ambiguous statutes and their application to different types of entities.<sup>22</sup>

**Business Income of Profitable Sole Proprietorships.**

Nearly all sole proprietorship income was subject to SECA and individual income taxes in 2004 . CBO found that almost 99 percent of net income attributable to profitable nonfarm sole proprietorships was included in the SECA tax base (see Table 4).<sup>23</sup> Among farmers with positive net income, 92 percent of their income was included in the SECA tax base.

**Income of Profitable Partnerships.** Only about half of individuals’ income from profitable partnerships was included in the SECA tax base in 2004, in CBO’s estimation. The income omitted from the SECA tax base reflects, at least in part, an exemption under the statute that explicitly excludes certain limited partnership income from the SECA tax base. It also could reflect an aggressive minority of LLCs trying to take advantage of the uncertainty regarding their status by claiming that same exemption. To gain additional insight, CBO examined three key pass-through items individually as well as in total.

*Guaranteed Payments.* Under current law, guaranteed payments to partners who are individuals should be included in the SECA tax base, except payments received by limited partners for reasons unrelated to the personal services they provide to the partnership. CBO estimates that partners of profitable firms included 81 percent of guaranteed payments in their SECA tax base (see Table 5). The share was fairly uniform among entity types, varying (with one

22. The IRS has identified unincorporated businesses as a major source of noncompliance with the individual income tax, accounting for 80 percent of the \$245 billion gross individual income tax gap in 2001. This report does not directly examine that phenomenon (although the results here are affected by negative business income, which is a common consequence of noncompliance). Instead, it focuses on the possibility that noncorporate business income as reported for income tax purposes might be improperly excluded from the SECA tax base. For more details on non-compliance, see Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (August 2, 2007), [www.irs.gov/uac/Treasury,-IRS-Release-Report-on-Improving-Voluntary-Compliance](http://www.irs.gov/uac/Treasury,-IRS-Release-Report-on-Improving-Voluntary-Compliance).

23. For sole proprietorships, firms reporting positive net income on Schedule C or F were deemed profitable. For partnerships, firms for which the sum of net business income, net rental income, and guaranteed payments, minus section 179 deductions, was positive were deemed profitable.

**Table 4.****Share of Net Income or Loss Included in the SECA Tax Base, by Type of Entity, 2004**

(Percent)

	Proportional Share of Business Income Only		All Pass-Through Items	
	Entities with Positive Net Income	Entities with Net Loss	Entities with Positive Net Income	Entities with Net Loss
Sole Proprietors				
Nonfarm	99	11	99	11
Farm	92	16	92	16
Partners in or Members of:				
General partnerships	66	16	45	17
Limited partnerships <sup>a</sup>	36	6	32	6
Limited liability companies	58	16	52	15
Limited liability partnerships	89	18	86	19
Other partnerships	59	6	56	5
Unknown type of partnership	n.a.	n.a.	20	1

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; n.a. = not available (because partnership type and specific pass-through items are identified together).

a. Includes income from both general partners and limited partners in the limited partnership.

minor exception) between 74 percent and 92 percent for all types in both years.<sup>24</sup>

*Proportional Shares of Business Income.* Unlike guaranteed payments, the treatment of proportional shares of business income varies significantly by entity type. By statute, such income is excluded from the SECA tax base of limited partners. Furthermore, neither the statute nor IRS rulings have definitively addressed whether shares passed through to LLC members must be included in the SECA tax base. Overall, 64 percent of shares passed through from partnerships to individuals were included in the SECA tax base in 2004 (see Table 5). That percentage represents a slight decline from 2001.

Among entity types, those proportions varied widely. Limited liability partners included the highest percentage

of their proportional shares in their SECA tax base (89 percent—see Table 4); the shares distributed by limited partnerships were the least likely to be included in the SECA tax base (36 percent). Those figures are not zero primarily because limited partnership entities include people who are general partners (who must include their proportional shares in the SECA tax base) as well as individuals who are limited partners (who are not required to include that income in the SECA base).

The data suggest that most members of LLCs, despite the possible opportunity to take a more aggressive position and behave like partners in limited partnerships, instead behave like partners in general partnerships. In 2001, the percentage of shares distributed by LLCs that were included in the SECA tax base was 64 percent, CBO estimates—5 percentage points lower than for general partnerships but 19 percentage points higher than for limited partnerships.<sup>25</sup> In 2004, the corresponding figure for LLCs was 58 percent—8 percentage points

24. The exception, occurring in 2001, was the relatively small “other partnerships” category (which consists primarily of foreign partnerships), in which only 59 percent of guaranteed payments were included in the SECA tax base. For the breakdown by entity type, see Congressional Budget Office, “Share of Partnership Income or Loss Included in the SECA Tax Base, by Type of Entity and Pass-Through Item, 2001 and 2004,” supplemental material for *The Taxation of Capital and Labor Through the Self-Employment Tax* (September 2012), Supplemental Table 12.

25. For the 2001 figures, see Congressional Budget Office, “Share of Net Income or Loss Included in the SECA Tax Base, 2001,” supplemental material for *The Taxation of Capital and Labor Through the Self-Employment Tax* (September 2012), Supplemental Table 4, column 1.

**Table 5.**  
**Share of Partnership Income or Loss**  
**Included in the SECA Tax Base, by**  
**Degree of Participation and**  
**Pass-Through Item, 2004**

(Percent)

	Entities with Net Income	Entities With Net Loss
Degree of Participation		
Material (Or nonpassive)	65	8
Nonmaterial (Or passive)	15	5
Pass-Through Item		
Guaranteed payments	81	15
Proportional share of business income	64	14
Proportional share of rental income	10	13
All Pass-Through Items (Including unknown)	49	7

Source: Congressional Budget Office.

Note: As specified in section 469 of the Internal Revenue Code, material participation is defined, for income tax purposes, primarily in terms of hours worked. It does not apply for Self-Employment Contributions Act (SECA) purposes.

lower than for general partnerships but 22 percentage points higher than for limited partnerships (see Table 4).

*Rental Income.* Rental income is subject to SECA taxes only if it is received by a real estate dealer as a result of a business transaction. Because most rental income is received by passive investors, only about 10 percent of it shows up in the SECA tax base, CBO estimates (see Table 5).

*All Pass-Through Income.* Overall, limited liability partners included the highest percentage of their income in the SECA tax base—more than 80 percent in both years, according to CBO (see Table 4). That outcome largely reflects the fact that LLPs do not typically invest in real estate. In contrast, partners in limited partnerships included relatively little of their income (about 32 percent in 2004) in the SECA tax base. (Partners in entities that could not be identified actually included an even lower percentage, which suggests that they probably are limited partners.)

Among other types of partnerships, the share of total income included in the SECA tax base depended largely on the sources of that income. Partners in general partnerships included a higher percentage of their income

in the SECA tax base in 2001 than did LLC members, but the reverse was true in 2004 (compare column 3 in the body of Table 4 with that of Supplemental Table 4). That change reflects a shift in what types of income were passed through to partners between the two years. Among members of general partnerships, only rental income increased between 2001 and 2004, while the business income of LLC members almost doubled.

**Sole Proprietorship and Partnership Losses.** The losses of unprofitable sole proprietorships and partnerships affect the SECA tax base when they are used to partially offset income from other (profitable) businesses. If there is no other business income to offset, losses are simply excluded from the SECA tax base. CBO estimates that in 2004 only 11 percent of the losses of nonfarm sole proprietorships and 16 percent of the losses of farm sole proprietorships were used to partially offset other self-employment income (see Table 4). The figures for general partnerships, LLCs, and LLPs were slightly higher, ranging between 15 percent and 19 percent. For limited partnerships and other (mostly foreign) partnerships, a lower percentage of losses, ranging between 5 percent and 6 percent, were used to offset other income.

## Comparing Labor and Capital Income in the FICA and SECA Tax Bases

CBO estimates that labor's share of the SECA-HI tax base was 58 percent in 2004 (see Table 6). To derive that estimate, CBO defined labor income as the portion of an owner's business income that would properly be subject to the FICA-HI tax if the business was incorporated. By law, that amount must represent "reasonable compensation." The remaining amounts of the SECA tax base are attributed to capital.<sup>26</sup>

CBO also compared the way in which labor and capital income of the self-employed is treated with how that income would have been treated if the same people worked for others and were covered by FICA. CBO estimates that 65 percent of capital income of the self-employed was included in the SECA-HI tax base in 2004 (see Table 7); none of that income would have been included in the FICA tax base. In contrast, only 44 percent of labor income of the self-employed was included in the SECA-HI tax base in 2004—the remaining

26. If labor income exceeds business income, however, the negative difference is not necessarily attributed to capital. That situation is discussed in more detail below.



**Table 6.**  
**Taxable Labor Income as a Share of**  
**the SECA Tax Base, by Type of Entity,**  
**2004**

	Percentage of Entity's Tax Base
Sole Proprietors	
Nonfarm	65
Farm	64
Partners in or Members of:	
General partnerships	43
Limited partnerships <sup>a</sup>	34
Limited liability companies	53
Limited liability partnerships	20
Other partnerships	18
All Types of Entities (Excluding unknown)	58

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act.

- a. Includes income from both general partners and limited partners in the limited partnership.

56 percent would have been included in the FICA tax base if the self-employed had worked for someone else.

On balance, the exclusion of more than half of labor income from the SECA-HI tax base and the inclusion of more than half of capital income in that tax base probably encouraged people to choose self-employment over working for another person. The aggregate SECA-HI tax base was 76 percent of the hypothetical FICA-HI tax base that self-employed workers would otherwise face—that is, total labor income. (That percentage is computed by dividing the last row of Table 7, column 1, by the last row of Table 6; that is,  $44/58 = 76$  percent.)<sup>27</sup> The difference between the FICA-HI and SECA-HI tax bases, however, is explained by the opportunity to exclude the portion of labor income that exceeds the net income of all of a taxpayer's businesses. Without that offset, the SECA-HI tax base of taxpayers reporting positive self-employment

27. The 44 percent from Table 7 represents SECA labor income divided by total labor income. The 58 percent from Table 6 represents SECA labor income divided by SECA total income. Dividing 44 by 58 is the equivalent of SECA total income divided by total labor income (which is equal to 76) and also to SECA total income divided by FICA total income because FICA total income equals total labor income.

income would have been roughly 5 percent greater than the hypothetical FICA-HI tax base.

In this analysis, CBO assumed that the alternative to being self-employed was working for someone else and that people who worked for someone else would not receive employer-provided health insurance. Data limitations prevented CBO from examining the labor income of the self-employed that is included in the SECA tax base but that would have been excluded from the FICA tax base if they had worked for someone else. Employers' contributions for health insurance are the most common form of labor income that is excluded from the FICA tax base. However, health insurance payments made by owners of unincorporated businesses on their own behalf are not excluded from the SECA tax base. Measuring the health insurance premiums included in the SECA tax base would reveal how much labor income would have been excluded had the self-employed worked for someone else and received health insurance—but that estimation requires information that is not available from tax data.<sup>28</sup>

### Measuring Total Labor Income

For people who are not self-employed, the distinction between labor income and capital income appears straightforward—wages and benefits are labor income, and interest, dividends, rents, and capital gains are capital income.<sup>29</sup> In this analysis, CBO assumes that the FICA tax base consists entirely of labor income and that all labor income from working for someone else (except

28. Although self-employed people can deduct health insurance expenses on their income tax return, that line item includes expenses of certain S corporation shareholders and excludes amounts paid during months in which the beneficiary was also covered by an employer's plan (or by the plan of a spouse's employer). The deduction amounted to less than 5 percent of the SECA tax base in 2004. On the FICA side, figures from the national income and product accounts published by the Bureau of Economic Analysis indicate that approximately 7 percent of labor income (in the form of employer-provided health insurance benefits) was excluded from that tax base in 2004.

29. Economists generally agree that wages reflect more than just the return on pure labor. For example, a portion of wages may represent the return on knowledge and skills obtained through education and experience—what is often referred to as "human capital." See Jacob Mincer, "Investment in Human Capital and Personal Income Distribution," *Journal of Political Economy*, vol. 66, no. 4 (August 1958), pp. 281–302. For some people, such as celebrities, a portion of their wages can be a return on their fame—a form of intangible capital analogous to a company's brand name. In this report, CBO uses the FICA-HI tax base as the definition of labor income, which includes the wages that are attributable to a return on human capital as well as to a return on other intangible assets.

**Table 7.****Shares of Capital and Labor Income Included or Not Included in the SECA-HI Tax Base, by Type of Entity, 2004**

(Percent)

	Included in the SECA-HI Tax Base	Total	Not Included in the SECA-HI Tax Base	
			Reported as Self-Employment Income on Schedule SE, but Offset by Negative Nonlabor Income	Not Reported as Self-Employment Income on Schedule SE
<b>Capital Income</b>				
Sole Proprietors				
Nonfarm	94	6	5	1
Farm	82	18	10	9
Partners in or Members of:				
General partnerships	34	66	4	62
Limited partnerships <sup>a</sup>	30	70	2	68
Limited liability companies	48	52	2	50
Limited liability partnerships	88	12	1	12
Other partnerships	17	83	1	82
All Types of Entities (Excluding unknown)	65	35	3	32
<b>Labor Income</b>				
Sole Proprietors				
Nonfarm	57	43	27	16
Farm	29	71	19	51
Partners in or Members of:				
General partnerships	24	76	28	48
Limited partnerships <sup>a</sup>	16	84	10	74
Limited liability companies	21	79	23	56
Limited liability partnerships	54	46	14	32
Other partnerships	9	91	83	7
All Types of Entities (Excluding unknown)	44	56	27	29

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; HI = Hospital Insurance (Medicare Part A).

a. Includes income from both general partners and limited partners in the limited partnership.

employers' contributions for health insurance) is subject to FICA taxes.<sup>30</sup>

30. One study found a small amount of capital income in the FICA tax base in the case of certain owners of privately held C corporations seeking to avoid corporate income taxes. That income was not considered in this analysis. See Nicholas Bull and Paul Burnham, "Taxation of Capital and Labor: The Diverse Landscape by Entity Type," *National Tax Journal*, vol. 61, no. 3 (September 2008), p. 416.

For people who are self-employed, the distinction between labor income and capital income is less clear. If asked, most such taxpayers probably would not be able to identify which portion of their self-employment income represents wages and which is a return on capital investments. And although various groups have proposed ways to modify the SECA tax base, research on the

relative contributions of labor and capital to self-employment income is sparse.<sup>31</sup>

In this report, CBO estimates labor income for the owners of sole proprietorships and partnerships in the following way:

- Identifying businesses that are required to report the reasonable compensation (a proxy for labor income) of their owners,
- Using those businesses to statistically estimate the relationship between reasonable compensation and other factors (such as industry and gross receipts) that are reported by unincorporated businesses, and
- Imputing reasonable compensation to unincorporated businesses as if those same relationships applied to them. (A more detailed discussion of the methodology can be found in Appendix A.)

The experiences of S corporations provide some information on reasonable compensation.<sup>32</sup> Although they are taxed as pass-through entities, like sole proprietorships and partnerships, S corporations are required to report the reasonable compensation of their owners. Shareholders in such entities are not considered self-employed, so their shares of the company's profits are not subject to the

SECA tax (although they are subject to the individual income tax). Instead, amounts reported as "compensation of officers" are subject to FICA taxes, just as if the owner were an employee.

Although amounts reported by corporations as compensation of officers are supposed to represent reasonable compensation, the reported amounts cannot be equated to labor income because most S corporations have an incentive to misreport that amount. Reporting compensation of officers that is below labor income results in lower FICA taxes for the owners. By minimizing compensation, owners maximize their profits. A taxpayer who is the sole owner of an S corporation could achieve that result by claiming that the fair market value of his or her services was lower than it actually is.<sup>33</sup>

How multiowner S corporations respond to the incentive to report compensation of officers that is less than labor income depends on the number of owners and their respective roles. If all owners contribute services roughly in proportion to their ownership shares, the incentive is to report compensation that is less than labor income regardless of the number of owners. However, if one owner performs a share of the services that is disproportionate to his or her ownership share, the incentives would be mixed. Avoiding the FICA tax remains a priority, but so is receiving fair compensation for services performed (see Box 1).

CBO estimated that underreporting by S corporations declined as the number of owners increased from one to six. Underreporting was not observed in CBO's estimates among S corporations with six or more owners. When imputing total labor income to sole proprietorships and partnerships, CBO based the imputation on the relationship between compensation of officers and characteristics of the business for S corporations, correcting for the underreporting found in the S corporation data.

31. The lack of empirical evidence reflects both methodological and conceptual challenges. Most researchers do not have access to data that could provide information on the labor and capital components of self-employment income. Tax analysts also differ as to which items should be characterized as labor income and which as a return on capital. For example, many managers of investment funds receive a portion of their compensation in the form of a share of profits known as "carried interest." For tax purposes, carried interest received by general partners is treated as investment income not subject to the SECA tax. Tax experts disagree, though, on the nature of carried interest. The carried interest of fund managers has been characterized as labor income by people who object to its treatment as capital gains (see Victor Fleischer, "Two and Twenty: Taxing Partnership Profits in Private Equity Funds," *New York University Law Review*, vol. 83 [2008]) and as capital income by people who defend the current treatment (see David Weisbach, "The Taxation of Carried Interests in Private Equity," *Virginia Law Review*, vol. 94, no. 3 [May 2008]).

32. S corporations are legally indistinguishable from other corporations except in the way they are taxed under federal law (and the law of most states)—namely, they are not subject to the corporate income tax but rather pass their income through to their owners. Those owners may number no more than 100 and may not include other for-profit businesses or nonresident aliens.

33. Privately held C corporations (that is, corporations that are subject to the corporate income tax) also face incentives to misreport reasonable compensation. In the case of C corporations, however, the underreporting of reasonable compensation not only reduces the FICA taxes of owners but also increases corporate income tax liability (because the business will have fewer expenses to deduct). The two somewhat offsetting incentives presented by the corporate income tax would never be faced by sole proprietorships or partnerships. Therefore, the statistical analysis focused solely on S corporations.

**Box 1.****How the Number of Owners Affects Incentives to Mischaracterize Labor Income Under a Reasonable Compensation Standard**

The intent of the reasonable compensation standard that applies to owners of S corporations is to subject labor income to Federal Insurance Contributions Act (FICA) taxes but to exclude capital income. One practical result of the standard is to provide owners of S corporations with an incentive to mischaracterize labor income as capital income, thereby minimizing their FICA tax liability. Single-owner firms can respond to that incentive without constraint (other than enforcement by the Internal Revenue Service). Multiowner firms, however, face some internal constraints on such behavior that limit their opportunities to mischaracterize income. Those constraints are a function of the number of owners and the extent to which the labor contribution of those owners is similar to their capital contributions. The two examples below illustrate contrasting cases when a firm has two owners.

Mary and John are owners of an S corporation that earns \$100,000 in a year, half of which is paid out in labor costs (compensation of officers and FICA taxes) and half of which is passed through to the owners as profits. Mary owns 80 percent of the shares and receives a corresponding share of the passed-through profits. John contributes 80 percent of the labor and is compensated accordingly. Each owner can leave the company if dissatisfied with his or her share of the combined return on capital and labor. When income is properly characterized, Mary's after-tax income is \$36,257, and John's is \$32,526 (see the top panel of the table).

Mischaracterizing labor income as capital income would increase their combined after-tax income from \$68,783 to \$75,000, but one of the two owners would be worse off. John's after-tax income would drop by more than half, whereas Mary's would nearly double. It is impossible in those circumstances to

mischaracterize the nature of the income without causing John's after-tax income to decline. It would not be in John's self-interest to go along with a plan that did not accurately characterize the nature of the income for each owner.

In contrast, if both Mary and John owned 50 percent of the shares and contributed 50 percent of the labor, then all income could be characterized as a return on capital, and both Mary and John would be equally better off (see the bottom panel of the table). With labor income mischaracterized as capital income, the combined after-tax income of the two owners would increase by \$6,218—with each owner receiving half of that amount (\$3,109). In that scenario, both owners would be better off if they claimed that all of their income was derived from capital.

The difference between the two examples is the disparity between labor and capital contributions—a difference of 60 percentage points in the first example (an 80-20 split) and none in the second example (a 50-50 split). How disparate can the labor and capital contributions be before it becomes impossible to make both owners better off? In this particular case—a very special one in which there are only two owners and each owner receives the same before-tax income—the greatest such disparity is slightly less than 10 percentage points. Specifically, when Mary provides 54.52 percent of capital and 45.48 percent of labor, mischaracterizing labor income makes her better off by \$6,539 but makes no difference for John. Examples with more owners, or examples in which owners receive differing amounts of before-tax income, will have different break-even points than this example. Nevertheless, the fundamental principle still holds—namely, that mischaracterization is easier when each owner contributes shares of labor and capital to the firm that are roughly equal to one another.

Continued

## Box 1.

Continued

## How the Number of Owners Affects Incentives to Mischaracterize Labor Income Under a Reasonable Compensation Standard

### Income of Owners of a Two-Person S Corporation Under Two Scenarios

(Dollars)

	Proper Characterization of Income		Mischaracterization of Income	
	Mary	John	Mary	John
<b>Income When Owners' Labor Contributions Differ from Their Capital Contributions</b>				
Before-Tax Income				
From wages (Officers' compensation)	9,289	37,157	0	0
Employer's share of FICA	711	2,843	0	0
From passed-through profits	40,000	10,000	80,000	20,000
Total Before-Tax Income	50,000	50,000	80,000	20,000
Individual Income Tax				
On wages	2,322	9,289	0	0
On passed-through profits	10,000	2,500	20,000	5,000
FICA Tax (Employer's and employee's shares)	1,421	5,685	0	0
Total Tax Liability	13,743	17,474	20,000	5,000
<b>After-Tax Income</b>	<b>36,257</b>	<b>32,526</b>	<b>60,000</b>	<b>15,000</b>
<b>Income When Owners' Labor Contributions Are the Same as Their Capital Contributions</b>				
Before-Tax Income				
From wages (Officers' compensation)	23,223	23,223	0	0
Employer's share of FICA	1,777	1,777	0	0
From passed-through profits	25,000	25,000	50,000	50,000
Total Before-Tax Income	50,000	50,000	50,000	50,000
Individual Income Tax				
On wages	5,806	5,806	0	0
On passed-through profits	6,250	6,250	12,500	12,500
FICA Tax (Employer's and employee's shares)	3,553	3,553	0	0
Total Tax Liability	15,609	15,609	12,500	12,500
<b>After-Tax Income</b>	<b>34,391</b>	<b>34,391</b>	<b>37,500</b>	<b>37,500</b>

Source: Congressional Budget Office.

Notes: For simplicity, this example assumes a 25 percent income tax rate and no other income or deductions. Employees and employers each pay 7.65 percent of wages in FICA taxes.

FICA = Federal Insurance Contributions Act.

The estimates of labor income in CBO's analysis are somewhat uncertain, however. Some of that uncertainty is common to other studies using similar statistical techniques. The results are also sensitive to some of the underlying assumptions used in this analysis. For example, CBO assumed that sole proprietorships and partnerships have the same characteristics as S corporations that are in the same industry and of similar size. However, the corporate structure of such firms may make them inherently different from unincorporated firms.

### Calculating Labor's Share of the SECA Tax Base

#### When Labor Income Exceeds Net Business Income

Estimates of the share of labor income that is included in the SECA tax base depend on the treatment of losses. In most cases, net business income is positive and exceeds the amount of labor income attributed to a sole proprietorship or partnership. In those cases, nonlabor income is positive and can be interpreted as capital income. When net business income is negative (that is, when the firm's expenses exceed its receipts), nonlabor income is also negative. Even when net business income is positive, it is occasionally less than estimated labor income, which also means that nonlabor income is negative.

The interpretation of those negative measures of nonlabor income is not straightforward and presents challenges for calculating labor's share of the tax base. For example, the tax code sometimes allows losses that are not truly economic. One such instance is when small businesses are allowed to deduct the full costs of equipment immediately, rather than over the lifetime of the asset. Attributing losses caused by such deductions entirely to capital would overstate labor's share of the SECA tax base.

To avoid such overstatements, CBO adopted a rule that was designed to minimize the differences between the FICA and SECA tax bases—namely, that for each taxpayer, labor income is summed across all entities and added to the tax base first (conforming to FICA procedures). If nonlabor income summed across all entities is positive, then it is attributed to capital and added to the tax base without any adjustment to labor income. If total nonlabor income is negative, however, labor income is reduced by that amount and nothing is attributed to capital. (The implications of that rule with respect to the results presented below are examined in Appendix B.)

### Shares of Income from Labor and Capital

CBO allocated three different measures of noncorporate business income between labor and capital. As the income measure narrowed, the share attributable to labor income increased (see Figure 2). In 2004, the shares derived from labor were as follows:

- 52 percent of the positive amount included in adjusted gross income for income tax purposes,
- 58 percent of the amount subject to the HI tax, and
- 73 percent of the amount subject to the OASDI tax.<sup>34</sup>

CBO found that labor income represented a higher share of the SECA-HI tax base for sole proprietors than for partners. Among partners in different types of partnerships, the split between labor and capital income varied considerably, according to CBO's estimates. In 2004, 65 percent of the SECA-HI tax base for nonfarm sole proprietors was derived from labor (see Table 6). For farm sole proprietors, labor's share was virtually the same—64 percent. Among partners, the share of labor income was highest for LLC members—53 percent. For partners in general partnerships, 43 percent of the SECA-HI tax base was labor income. For partners in the remaining types of entities, labor's share was less than 35 percent. That finding is not surprising in the case of partners in limited partnerships (34 percent), given the traditional restrictions on material participation (which gives rise to labor income) by limited partners.

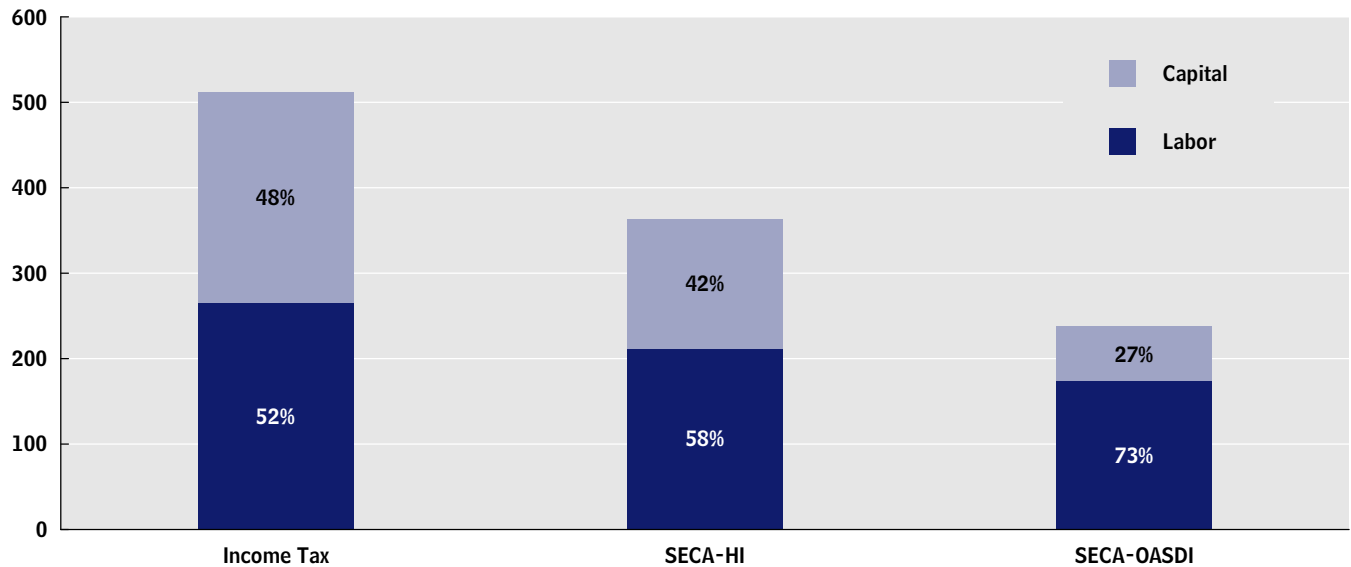
However, the low share of labor income in the SECA-HI base for limited liability partners (20 percent) may seem

34. Many studies have assumed that 65 percent of proprietors' income comes from labor. In its analysis of macroeconomic activity, CBO has relied on that figure. The labor shares estimated in this report, however, are shares *in a tax base* and thus are not directly comparable to labor shares of proprietors' income generally. If methods used to impute labor income in this report were extended to all proprietors' income, they would generate a labor share between 48 percent and 63 percent. That is lower than the assumption of 65 percent used in other studies largely because the derivation of that figure implicitly treats income attributable to partners that are not individuals differently than such income was treated in this analysis.

**Figure 2.**

## Labor and Capital Shares of the Business Income of Profitable Sole Proprietorships and Partnerships in Various Tax Bases, 2004

(Billions of dollars)



Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; HI = Hospital Insurance (Medicare Part A); OASDI = Old-Age, Survivors, and Disability Insurance.

surprising considering that most partners in those entities are very involved in the day-to-day operation of their business. Much of the explanation lies in the high gross income of LLPs, which are found largely in the professional services industry. Evidence from CBO's analysis of S corporations indicates that labor income increases as gross receipts rise, but at a slower rate. As a result, labor's share of income could be expected to be smallest among partnerships with the highest gross receipts. In 2004, LLPs averaged \$1.6 million in gross receipts, and all other partnerships averaged \$0.4 million.<sup>35</sup> Despite the small labor percentage, however, average labor income per partner was twice as high for LLPs as for any other type of partnership. Furthermore,

LLPs had the highest net income per partner of all the entity types, despite not having a disproportionate share of assets on their books. The most likely explanation for those results is that the net income of LLPs mostly represents a return on intangible capital, such as the reputation of the brand, research and development, and established institutional procedures (for example, having templates for legal documents).

### Comparing the FICA and SECA Tax Bases

Three different measures of the components of non-corporate business income provide insight into the extent to which the SECA-OASDI and -HI tax bases deviate from the standards of the corresponding FICA tax bases:

- The percentage of the labor component that is included in the HI tax base (100 under FICA, assuming no employer-paid health insurance),
- The percentage of the capital component that is included in the HI tax base (zero under FICA), and

35. Because of the limit on the number of owners an S corporation can have, the sample of S corporations used to calibrate the imputation of labor income did not have any firms with gross receipts as high as those of the largest partnerships (including many LLPs). Thus, the resulting imputation of labor income to partnerships with high gross receipts could reflect insufficient information about the proper relationship of labor and gross receipts at that level.

- The percentage of the capital component that is included in the OASDI tax base (also zero under FICA).<sup>36</sup>

In 2004, approximately 65 percent of capital income was included in the SECA-HI tax base (see Table 7). For sole proprietors and limited liability partners, that figure exceeded 80 percent. For owners of all other types of partnerships, however, the figure was less than 50 percent. Only 3 percent of capital income was offset by negative nonlabor income, and almost one-third was not accounted for on Schedule SE (the form on which SECA tax liability is calculated). When only income below the OASDI ceiling was considered, the share of capital income included in the tax base dropped to 26 percent (see Table 8).

Unlike the FICA-HI tax base, which includes all labor income, the SECA-HI tax base includes less than half (44 percent in 2004) of the labor income from unincorporated businesses, CBO estimates. Only nonfarm sole proprietors and limited liability partners included more than half of their labor income in the SECA-HI base; owners of all other entity types included less than 30 percent of their labor income (see Table 7). Offsetting negative income accounted for more than 45 percent of the labor income excluded from the SECA-HI tax base.<sup>37</sup>

Overall, the SECA-HI tax base was roughly 76 percent of what the FICA tax base would have been if owners had been taxed on their correctly reported reasonable

36. The percentage of the labor component subject to the OASDI tax is not measured. Unlike the HI tax, the OASDI tax is capped, so labor income in excess of the OASDI maximum is not taxed. The difference between the respective labor components of the FICA and SECA tax bases probably results from differences between wage earners and self-employed people in the distribution of earnings above and below the OASDI maximum rather than differences in the way labor income is taxed under FICA and SECA.

37. That percentage is computed from values in the last row of the labor income panel of Table 7: Specifically, the amount in column 3 (27 percent) is divided by the amount in column 2 (56 percent). Those results are very sensitive to how negative income is handled in the calculation. CBO deemed capital and labor income that is offset by negative nonlabor income to be excluded from the SECA tax base, even if that income was reported by an entity whose net income was accounted for on Schedule SE (see Appendix B for more details). Such offsets are not available under the FICA tax, so including such income in the SECA tax base would obscure a major difference between the two tax bases.

compensation (see footnote 27 for the derivation of that number). That percentage varies considerably by entity type, however. The SECA-HI tax bases for partners in limited partnerships, LLC members, and farm sole proprietors were each less than half of the corresponding FICA tax base. For partners in LLPs, in contrast, the SECA-HI tax base was more than double what it would have been under FICA.

## Alternative Options for Defining the SECA Tax Base

The SECA tax base could be modified in a number of ways. The following options would either clarify the tax treatment of different types of partnerships or include less capital income in the SECA tax base (and make the SECA tax base more similar to the FICA tax base in that regard). The options use three different approaches to measure self-employment income. One of those approaches, a material participation standard, would standardize the SECA tax base across different types of partnerships. The other two approaches, a reasonable compensation standard and a safe-harbor exclusion for capital, would seek to reduce capital income in the tax base—the former by focusing on a more accurate measure of labor income, and the latter by allowing taxpayers to use a simple rule for calculating excludable capital income.

Although those approaches have been combined in some proposals, CBO analyzed each approach separately. The three approaches were based on options described in publications of the staff of the Joint Committee on Taxation, the American Institute of Certified Public Accountants, and the American Bar Association's Section of Taxation. (See Appendix C for details.) Other approaches and combinations of approaches are also possible.

All of the estimates presented below assume that the options—if enacted—would not affect the supply of labor or the rate of saving. Such effects might well occur, but they would probably be noteworthy only in the case of the reasonable compensation standard. CBO did consider various other behavioral responses, some qualitatively and others quantitatively: how taxpayers would characterize their self-employment income (as labor or capital), how they would characterize their partnership participation (as material or nonmaterial), and how firms



**Table 8.**

**Shares of Labor and Capital Income Included in the SECA Tax Base Relative to the FICA Tax Base, 2004**

(Percent)

	Share of Labor Income Included in the HI Tax Base	Share of Capital Income	
		HI Tax Base	OASDI Tax Base
FICA Tax Base <sup>a</sup>	100	0	0
SECA Tax Base			
Under current law	44	65	26
Under a material participation standard	45	69	27
Under a reasonable compensation standard	34	0	0
Under a safe harbor for capital	42	62	25

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; FICA = Federal Insurance Contributions Act; HI = Hospital Insurance (Medicare Part A); OASDI = Old-Age, Survivors, and Disability Insurance.

a. Specifically, the tax base of employees with no employer-provided health insurance.

would allocate their investments (between tangible and intangible assets).

**The Material Participation Standard**

The income tax code treats owners who are material participants (that is, actively involved in a firm’s management) differently than nonmaterial (or passive) participants for purposes of allowing business losses. In this option, material participants—regardless of a firm’s form of organization—would be treated the way general partners are under current law, and nonmaterial participants would be treated the way limited partners are under current law. By applying the same test to all multiowner entities, this option would clarify the SECA tax obligations of limited partners and LLC members.

The primary test for material participation is whether an individual engages in the operation of a business for more than 500 hours during a given year. If the person is the primary or only participant in operating the company, lower hourly thresholds apply. Furthermore, if the person has met any of the applicable criteria in 5 of the past 10 years (3 in the case of personal service partnerships), then he or she is deemed a material participant in the current year as well.<sup>38</sup>

This option would impose SECA taxes on the passed-through share of the business income of limited partners who are material participants, thereby capturing the labor income associated with their material participation.<sup>39</sup>

However, the option would exempt the passed-through share of business income of general partners who are not material participants—amounts that presumably would primarily include capital income. Among limited partnerships and LLCs that currently follow the regulations proposed by the Treasury in 1997, it is unlikely that any partners would have more of their income subject to the SECA tax under this option. Some partners, however—specifically, LLC members who provide fewer than 500 hours of labor but who have the authority to sign binding contracts on behalf of the company—would have less income subject to the SECA tax.

**Effects on the Tax Base.** Replacing the distinction between general and limited partners with a material

38. “Personal service partnerships”—the term used in the regulations—are essentially partnerships in what is referred to as the professional services industry elsewhere in this report. The details of the test for material participation can be found at Internal Revenue Service, “Passive Activity Loss ATG—Exhibit 4.1: Material Participation” (December 2004), [www.irs.gov/businesses/small/article/0,,id=146837,00.html](http://www.irs.gov/businesses/small/article/0,,id=146837,00.html).

39. Under current law, the material participation standard is lower for real estate rental activity than for other activities. Qualifying under that lower standard does not conform to the spirit of this standard for SECA tax purposes—it would include income properly classified as passive in the tax base. Therefore, under this option, no passed-through real estate rental income in excess of what was already included under current law was deemed to be subject to the SECA tax.

participation standard would have increased the SECA-HI tax base, on net, by approximately 3 percent in 2004, CBO estimates.<sup>40</sup> The income of material participants that was added to the SECA tax base would have exceeded the newly excluded income of nonmaterial participants—largely because the income of nonmaterial participants who are not limited partners is generally not reported on Schedule SE, despite the requirement that it be included in the SECA tax base. For example, only about 14 percent (or \$3 billion) of the income of passive general partners was accounted for on Schedule SE in 2004, in CBO’s estimation.<sup>41</sup> Excluding that \$3 billion under the material participation standard would have been more than offset by including the nonpassive income of limited partnerships and LLCs under the standard.

**Effects on the Taxation of Capital Income.** Under the material participation standard, the amount of capital income of material participants that became subject to the SECA tax would exceed the capital income of nonmaterial participants that would no longer be taxed. Overall, CBO estimates, the share of such income included in the SECA-HI tax base would have increased from 65 percent to 69 percent in 2004 (see Table 8). Only among partners in general partnerships would the included share of capital income have declined, and then by just 4 percentage points—from 34 percent under current law to 30 percent under the option (see Table 9, columns 1 and 2). Among limited liability partners, there would have been virtually no change; about 88 percent of their capital income would have been included in the SECA-HI tax base under both current law and this option. But among owners of the other entity types, the share of capital income included in the SECA-HI base would have increased: by 7, 15, and 23 percentage points

40. CBO estimated the changes to the tax base under this standard (and the other policy alternatives). Official revenue estimates of legislative proposals are prepared by the staff of the Joint Committee on Taxation. Such estimates would link the changes in the tax base to changes in revenue and might also incorporate different imputation methodologies and behavioral assumptions than CBO used in this report.

41. Under current law, 67 percent of nonpassive general partnership income was accounted for on Schedule SE in 2004 instead of the mandated 100 percent. Because the material participation standard would not increase the taxable share of such income, CBO assumed the same level of compliance as under current law. The agency adopted a similar assumption with respect to guaranteed payments for all types of partnerships.

for LLC members, partners in limited partnerships, and partners in other partnerships, respectively. Considering only amounts below the OASDI ceiling would have raised the share of capital income included in the tax base from 26 percent to 27 percent. (Those amounts are not shown in the tables.)

**Effects on the Taxation of Labor Income.** A material participation standard would have increased the share of labor income included in the SECA-HI tax base by almost 2 percentage points in 2004, CBO estimates—from just below 44 percent to just above 45 percent (see Table 8). Even among members of partnerships (the entity types that are directly affected), the share would have increased only from 22 percent to 25 percent (not shown in the tables). The increase among partners would have been approximately 2 percentage points if negative nonlabor income was not allowed to offset labor income. In the most extreme case—that of partners in limited partnerships—an additional 13 percent of labor income would have been accounted for on Schedule SE under the material participation standard (see Table 9), but nearly half of that increase would have been offset by negative nonlabor income. Hence, only 7 percent of the labor income of partners in limited partnerships would have been added to the SECA-HI tax base. Only among partners in general partnerships would the share of labor income accounted for on Schedule SE have declined under this option (by 5 percentage points). Because the share offset by negative nonlabor income also would have declined, however, the share included in the SECA-HI tax base would still have increased, on net, by almost 3 percentage points.

**Certain Effects on Behavior.** CBO’s estimates of the effects of a material participation standard on labor and capital income do not account for certain actions that taxpayers can take to minimize their SECA tax liabilities. Although specific rules determine whether a taxpayer is a material participant, there is also a “facts and circumstances” test that partners—particularly those who are close to the hours threshold—can apply instead, which may result in a more advantageous classification. Under current law, partners with positive net income have an incentive to classify themselves for income tax purposes as nonmaterial participants (so that passive losses from other entities have some income to offset); partners with net losses have an incentive to classify themselves as material participants (so that those losses can offset any other type

**Table 9.**

**Changes in Shares of Capital and Labor Income in Self-Employment Income Under a Material Participation Standard, by Type of Entity, 2004**

	Included in the SECA-HI Tax Base		Accounted for on Schedule SE (Including amounts offset by losses)	
	Current Law (Percent)	Difference Between Current Law and a Material Participation Standard (Percentage points)	Current Law (Percent)	Difference Between Current Law and a Material Participation Standard (Percentage points)
<b>Capital</b>				
Sole Proprietorships				
Nonfarm	94	-1	99	0
Farm	82	*	91	0
Partnerships				
General	34	-4	38	-4
Limited	30	15	32	17
LLCs	48	7	50	8
LLPs	88	*	88	*
Other	17	23	18	24
All Types of Entities	65	4	68	5
<b>Labor</b>				
Sole Proprietorships				
Nonfarm	57	*	84	0
Farm	29	*	49	0
Partnerships				
General	24	3	52	-5
Limited	16	7	26	13
LLCs	21	3	44	7
LLPs	54	1	68	1
Other	9	4	93	-11
All Types of Entities	44	1	71	1

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; HI = Hospital Insurance (Medicare Part A); LLC = limited liability company; LLP = limited liability partnership; \* = between zero and 0.5 percentage points.

of income). This option would probably reinforce the incentives under current law for SECA-averse taxpayers.<sup>42</sup>

Because, in all likelihood, most partners are SECA-averse, the above estimates might overstate the amount of capital income that would become subject to SECA taxes under

this option. Specifically, partners without passive losses or other business gains do not have any incentive under current law to misclassify themselves, but they would have such an incentive if the material participation standard was applied to the SECA tax.

**The Reasonable Compensation Standard**

Under current law, S corporations and C corporations are required to report reasonable compensation earned by their shareholders, and FICA tax liabilities are computed on those amounts. This option would apply the same standard to sole proprietorships and partnerships,

42. Beginning in 2013, a tax rate of 3.8 percent will be applied to the passive partnership income of higher-income taxpayers as an “Unearned Income Medicare Contribution.” For the affected taxpayers, that change will greatly reduce their incentive to misclassify income.

including in the SECA tax base only the reasonable compensation paid to their owners. As a result, all capital income (as defined in this report) would be eliminated from that tax base.

**Effects on the Tax Base.** Imposing a reasonable compensation standard on unincorporated businesses in general would have decreased the SECA-HI tax base by 58 percent in 2004, CBO estimates. The SECA-OASDI tax base would have been reduced by roughly 52 percent under such a standard.

The smaller tax bases would result primarily from the exemption of capital income. In addition, even though more labor income from unprofitable firms would become subject to SECA, a reasonable compensation standard would create an incentive for some people to mischaracterize labor income as capital income, which would further reduce the tax base. Sole proprietors and partners would face the same incentives and opportunities to underreport reasonable compensation as owners of S corporations do under current law.

Under this standard, any income that sole proprietors could characterize as capital would be excluded from the SECA tax base. Unless the sole proprietors were Social Security seekers (that is, people who have little or no wage income but want to maximize their future Social Security benefits), they would find it beneficial to characterize as much income as possible as capital income and thus minimize their SECA tax liability. A sole proprietor could do that by claiming that the value of his or her services was lower than it actually was. Without a detailed record of precisely what services were performed, such a claim would be difficult for the IRS to refute, and the typically small amount of revenue at stake would probably make IRS challenges rare.

How partnerships would respond to such incentives to mischaracterize income would depend on the number of partners and their respective roles. If all partners contributed services roughly in proportion to their ownership shares, the incentives would be the same as those for sole proprietors. However, if one partner performed a share of the services that was disproportionate to his or her ownership share, the incentives would be mixed (see Box 1 on page 14).<sup>43</sup> The incentives would become more complex as the number of partners increased. Above some threshold, it would become too difficult to satisfy

all the partners by underreporting their compensation, and the incentive would disappear.

In this report, CBO simulates the effects of using a reasonable compensation standard to determine the SECA tax base in two steps: first, by imputing labor income to sole proprietorships and partnerships (and allocating each partnership's total labor income among the various partners) and, second, by imputing the amount of compensation that would be reported if compliance levels approximated those observed among S corporations (where the standard is in effect). The results for sole proprietors and partners differ sharply—an outcome driven by the observation that underreporting of reasonable compensation is greater among S corporations that have one owner than among S corporations that have multiple owners. Thus, if the reasonable compensation standard was limited to partnerships, the reduction in the SECA-HI tax base in 2004 would have been much smaller—only 26 percent instead of the 58 percent drop when sole proprietors are included.

**Effects on the Taxation of Capital Income.** By design, no capital income would have been subject to either SECA-HI or -OASDI taxes under a reasonable compensation standard (see Table 8). The exclusion of capital income by itself would have been enough to result in a smaller tax base for every type of entity.

**Effects on the Taxation of Labor Income.** CBO's analysis of S corporations suggests that many taxpayers would probably respond to a reasonable compensation standard by underreporting labor income. CBO thus estimates that the share of labor income that would have been included in the SECA-HI tax base under this option would have been 10 percentage points lower than under current law—barely one-third of the total (see Table 10). In the case of partnerships, however, the included share of labor income would have increased by about 21 percentage points, from 22 percent to 44 percent. (Among partnerships with more than five owners, CBO estimates, the included share would have been 100 percent.) The share of labor income included by sole proprietorships would have declined by 27 percentage points, from 56 percent to 29 percent. The lower inclusion rates for

43. Although Box 1 presents examples for S corporation owners with FICA tax liability, the incentives would be the same for partners subject to the SECA tax under reasonable compensation standards.

**Table 10.**

**Changes in Shares of Capital and Labor Income Included in the SECA-HI Tax Base Under Three Options, by Type of Entity, 2004**

	All Types of Entities	Sole Proprietorships	Partnerships
<b>Capital</b>			
Current Law (Percent)	65	94	43
Percentage-Point Difference Between Current Law and a:			
Material participation standard	4	-1	8
Reasonable compensation standard	-65	-94	-43
Safe harbor for capital	-2	-2	-2
<b>Labor</b>			
Current Law (Percent)	44	56	22
Percentage-Point Difference Between Current Law and a:			
Material participation standard	1	*	3
Reasonable compensation standard	-10	-27	21
Safe harbor for capital	-2	-2	-2

Source: Congressional Budget Office.

Note: SECA = Self-Employment Contributions Act; HI = Hospital Insurance (Medicare Part A); \* = between zero and 0.5 percentage points.

sole proprietorships are primarily responsible for the overall lower inclusion rate for labor income.

**Certain Effects on Behavior.** The ability to characterize labor income as capital income to the extent that a reasonable compensation standard allows would lower the price of an owner’s labor and probably induce owners, particularly those who work part time, to increase their hours of work. Furthermore, by removing capital from the SECA tax base, a reasonable compensation standard would lower the effective tax rate on capital and probably induce more investment.

**The Safe-Harbor Calculation of Capital Income**

This option would allow partners and sole proprietors to use a standard formula—a safe-harbor rule—to determine the amount of income that would be deemed excludable from the SECA tax base as deriving from capital. To determine their capital base, taxpayers would begin by summing up their capital assets, in the same manner that partnerships currently do when reporting their balance sheet to the IRS. To calculate their safe-harbor exclusion, taxpayers would then apply to the capital base a rate of return equal to 150 percent of the maximum applicable federal rate.<sup>44</sup> Those augmented rates of return were 5.99 percent in 2001 and 5.37 percent in 2004.

Certain types of assets would be excluded from the capital base. Assets that generate interest, dividends, and capital gains would not be counted because those sources of income are already excluded from the calculation of the SECA tax base under current law. Cash would be excluded in order to prevent sole proprietors from excluding capital income that was not generated by their business. Because there is no legal distinction between a sole proprietor’s personal holdings and those of his or her business, owners would otherwise be able to include all of their bank accounts and financial instruments on the balance sheet of their business and receive a correspondingly larger safe-harbor exclusion. (Mingling personal assets with business assets is much less likely in partnerships; a member of the partnership would probably prefer to keep his or her personal accounts separate from those of the business rather than giving the other partners a potential claim on those accounts.)

44. Applicable federal rates are calculated by the Internal Revenue Service to determine imputed interest that must be taxed or may be deducted in situations where below-market interest rates are being charged. The highest rates are calculated for instruments having a term of nine years or more. CBO applied the exclusion at the entity level, meaning that if the safe-harbor exclusion for one entity exceeded the taxable income of that entity, the unused portion could not be applied to the taxable income of another entity.

Under this option, the capital base would exclude most intangible assets (which account for the difference between the market value of a firm and the book value of the owner's capital account). Thus, firms that rely heavily on tangible assets would have a greater share of their capital income excluded than would firms that rely heavily on intangible assets. Designing and implementing a measure of intangible assets that could be used in a safe-harbor calculation would be difficult, however. It would require an estimate of each firm's market value, which would be highly imprecise in the absence of a public clearinghouse (analogous to the stock market) for the sale of unincorporated businesses.

The safe-harbor approach would also increase the administrative burden on sole proprietors (and certain smaller partnerships), who would have to begin reporting balance sheet information. However, only firms that chose to use the safe-harbor exclusion would have to file that information.

**Effects on the Tax Base.** Adopting the safe-harbor exclusion would have reduced the SECA-HI tax base by approximately 4 percent in 2004, CBO estimates—a much smaller reduction than would have occurred under a reasonable compensation standard.<sup>45</sup> Approximately 45 percent of the decline would have been attributable to income from partnerships, even though such income accounted for less than 25 percent of the tax base. That discrepancy reflects the extent to which partnerships are more capital-intensive than sole proprietorships (because of their larger size and the industries in which they are found, particularly real estate).

**Effects on the Taxation of Capital Income.** Most of the estimated decline in the SECA tax base would have resulted from the exclusion of capital income. CBO estimates that the share of capital income included in the SECA-HI tax base would have declined from 65 percent to 62 percent in 2004 (see Table 8). The share of capital income included in the SECA-OASDI tax base would

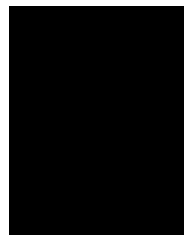
have decreased by 1 percentage point (from 26 percent to 25 percent).

A safe-harbor exclusion, with its fixed rate of return on the capital account, would not prevent substantial amounts of capital income from being taxed, for two reasons. First, the potential exclusion—that is, 5.37 percent of the capital account of profitable businesses in 2004—would have accounted for only 25 percent of capital income in the SECA-HI tax base, probably because the exclusion does not account for the return on intangible assets. That shortfall was most pronounced for limited liability partners and nonfarm sole proprietors. Second, even for owners of entity types for which the potential exclusion approached or exceeded capital income (partners in limited partnerships and members of LLCs), the safe-harbor exclusion would have had small effects. Those owners would not have been able to use more than 60 percent of the potential exclusion because their income was not subject to tax under current law (that is, the income was either offset by losses or was not reported on Schedule SE in the first place). For partners in limited partnerships and members of LLCs, that share reached 84 percent and 78 percent, respectively.

**Effects on the Taxation of Labor Income.** In cases where the safe-harbor amount exceeded capital income, it would also have excluded some labor income. As a result, the share of labor income included in the SECA-HI tax base would have decreased slightly, from 44 percent to 42 percent (see Table 8). Because the exclusion reduces both labor and capital income, the split between labor and capital income would have remained virtually the same as under current law.

**Certain Effects on Behavior.** CBO's estimates do not account for changes in firms' portfolios in response to a safe harbor. Using a uniform rate of return for computing the excludable amount of income would reduce firms' incentive to maximize the return on their assets. A firm realizing a rate of return that was higher than the safe-harbor amount—say, 10 percent—would be able to exclude only a portion of its capital income from its SECA tax base, whereas a firm realizing no return on its capital would be able to shelter some of its labor income from the SECA tax. Thus, the safe harbor would probably induce firms to invest more money in tangible capital and less money in intangible capital than would otherwise be optimal. That outcome would tend to reduce the SECA tax base even more.

45. CBO's estimate assumes that affected firms are limited to those that would be required to file balance sheets under current law (including sole proprietorships that would meet the criteria for filing a balance sheet if they were a one-owner S corporation). A safe-harbor exclusion would probably spur firms that are not required to file balance sheets to do so in order to claim the benefit, further shrinking the tax base.



## Appendix A: Imputing Labor Income to the Self-Employed

**A**nalyzing the taxation of labor and capital income through the self-employment tax involves distinguishing between those two components of the Self-Employment Contributions Act (SECA) tax base. However, because taxpayers do not report those two types of income separately on Schedule SE of their tax return (the form on which SECA tax liability is calculated), separating out that income can be difficult. Most taxpayers probably do not even know which portion of their business income results from their own labors and which results from their investments in capital. Even though analysts generally agree that the SECA tax base includes both labor and capital income, few analysts have attempted to measure those two portions of the tax base.

In this report, the Congressional Budget Office (CBO) isolates labor's share of the SECA tax base by focusing on the differences between that tax base and the Federal Insurance Contributions Act (FICA) tax base. Labor income is defined as the portion of a self-employed person's business income that would be subject to the FICA tax if the business was incorporated and its owner was treated like other employees.

To determine labor's share of the SECA tax base, CBO had to identify the labor income of partners and sole proprietors. To do that, CBO first identified a population that was similar to the self-employed but that reported labor compensation on their tax return. The labor income of that population was statistically related to variables that are reported by partnerships and sole proprietorships. Next, those relationships were applied to tax data reported by sole proprietorships and partnerships to derive an imputation of labor income. Because the imputation was done at the entity level, a third step was necessary to distribute labor income among individual partners. Those three steps resulted in estimates of the

labor content of sole proprietorship and partnership income in the individual income tax base.

Although all labor income of sole proprietors is included in the SECA tax base, some types of partnership income may be excluded. To isolate the portion in the SECA tax base, CBO had to identify the specific business entities contributing to each individual's tax base (along with their associated labor income) in a fourth step.

### Step 1: Statistically Analyze a Population Similar to the Self-Employed

Sole proprietorships and partnerships do not report the labor income of their owners to the Internal Revenue Service (IRS). However, other types of business entities are required to report compensation paid to their officers (or owners). That information can be used to derive estimates of the labor income of sole proprietorships and partnerships.

By law, corporations must report as "officers' compensation" the reasonable compensation of their owners. To the extent that such compensation was reported accurately, it would reliably measure labor income. However, that compensation is frequently reported inaccurately, and the incentive to misreport it differs for C corporations and S corporations.<sup>1</sup> Because the incentives for S corporations to misreport reasonable compensation are virtually identical to those that a sole proprietorship or partnership would face under the same reporting

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1. The theory behind the different incentives and the extent of misreporting are described in Nicholas Bull and Paul Burnham, "Taxation of Capital and Labor: The Diverse Landscape by Entity Type," *National Tax Journal*, vol. 61, No. 3 (September 2008).

requirement, CBO focused on S corporations in its analysis of reasonable compensation. That analysis consisted of two parts: relating reported officers' compensation to other variables that are also reported on tax documents filed by sole proprietorships and partnerships, and estimating the amount by which officers' compensation was underreported. In combination, those two parts produce the imputation parameters used in the next step of the analysis.

### Relating Officers' Compensation to Other Variables

CBO used regression techniques to relate reported officers' compensation to explanatory variables including gross receipts and several measures of firms' inputs. Officers' compensation was expected to rise with gross receipts, because the role of management expands as a firm's income increases. The other relationships with the firm's inputs were more ambiguous. Employees' labor (as measured by wages and salaries) could be either a complement to or a substitute for the labor of owners. Similarly, capital (as indirectly measured by variables such as depreciation and repairs) could be either a complement to or a substitute for labor.

The data for this portion of the analysis came from a subsample of the IRS's Statistics of Income (SOI) sample of corporate tax returns. The S corporation database used in the analysis included 216,804 tax returns from 2000 through 2004. In addition to the variables described above, CBO used dummies for each year, for profitable firms, and for 33 industries. All dollar amounts were converted to logs.

CBO estimated the imputation parameters in three stages. First, the agency used a probit regression to estimate the probability of a firm's reporting nonzero amounts of compensation. Second, CBO ran a linear regression using only the returns with nonzero values to estimate the amount of compensation. That regression corrected for selection bias that might arise because the sample omits records that reported officers' compensation of zero when the true figure was positive. CBO tested the results by applying the coefficients to the S corporations in the sample to determine whether, in total, they replicated the actual amount of officers' compensation reported. In fact, the log of the predicted total equaled the log of the reported total, but when converted back to levels, the predicted total fell far short of the reported

total. In the third stage, therefore, CBO adjusted the predicted levels to better correspond to the reported amounts. Firms were put into six classes of gross receipts, and a linear regression was estimated using the reported amount (in levels, not logs) as the dependent variable and the amount predicted in the second step as the explanatory variable. CBO applied the coefficients from each class to the amounts predicted in the second stage, and the results matched the reported total.<sup>2</sup>

### Estimating Underreported Income

The technique that CBO used to estimate underreporting of compensation by S corporations hinges on the assumption that underreporting is systematically related to the number of shareholders in a firm. As illustrated in Box 1 on page 14, the ability to make all shareholders better off by underreporting compensation depends on each shareholder's contribution of labor being roughly proportional to his or her contribution of capital. As the number of shareholders increases, that condition becomes more difficult to meet.

In this technique, CBO constructed a series of dummy variables that represent the incremental disincentive to underreport compensation associated with each additional shareholder; there was a dummy variable for all firms with two or more shareholders (sh2), another for firms with three or more shareholders (sh3), and so on up to nine or more shareholders (sh9).<sup>3</sup> Coefficients were estimated on each variable in the second stage of the statistical process described above. The interpretation of the coefficient on sh $x$  is the amount by which *average* compensation per owner is higher for an S corporation with  $x$  shareholders than for one with  $x-1$  shareholders. The coefficient should always be positive, so variables with negative or insignificant coefficients were eliminated until only those with significant positive coefficients

2. CBO used a similar three-stage technique to impute to sole proprietorships a capital account potentially eligible for the safe-harbor exclusion. In that case, only single-owner S corporations were used to estimate the regressions. Depreciation deductions proved to be the primary driver of the imputation.
3. Using sh $x$  for firms with exactly  $x$  shareholders would not represent an incremental effect and is thus inconsistent with the hypothesis that underreporting necessarily declines with the number of shareholders.



remained.<sup>4</sup> Ultimately, sh2, sh3, and sh6 were retained, meaning that no underreporting by firms with six or more owners could be statistically detected.

## Step 2: Apply That Analysis to Partnerships and Sole Proprietorships

In this step, CBO applied the parameters that it estimated in the first step to a sample of sole proprietorships and partnerships to determine two amounts: the amount of owners' compensation that would be reported by each entity, assuming the level of compliance observed among S corporations, and the total amount of labor income, assuming full compliance with the reasonable compensation standard. Some of the data for this analysis came from a subsample of sole proprietorships that includes all the Schedule Cs and Fs in the SOI sample of individual income tax returns. In 2001, 71,158 such forms were included in the sample; in 2004, the figure was 83,707. The rest of the data were drawn from the SOI Partnership file, consisting of a sample of Form 1065s filed by all multiowner unincorporated businesses. In 2001, the sample included 21,695 partnership returns; in 2004, the figure was 23,836.

For the "observed compliance" imputation, CBO applied the parameters of the first-stage probit regression to each sole proprietorship and partnership in the samples to estimate the probability that the firm would report its owners' compensation. On the basis of the resulting probabilities, firms were randomly selected to receive an imputation of a compensation amount. Values of shx were then calculated for each partnership (they are always zero for sole proprietorships), and the parameters of the linear regression (from the second stage of Step 1) were applied. Finally, firms were classified by gross receipts, and the imputed amounts were adjusted by the parameters estimated in the third stage of the first step.

As a simple illustration, assume that the second stage of the first step yielded the following equation:

$$\text{Log (officers' compensation)} = 1.04 + 0.70 * \text{Log (gross receipts)} + 0.24 * \text{sh2}.$$

4. That practice compromises the ability to interpret all of the coefficients clearly, but it is necessary to avoid implausible (that is, negative) imputation amounts.

Based on the above equation, a sole proprietorship with \$100,000 of gross receipts (and selected to receive a positive amount) would receive an imputation of reasonable compensation under observed compliance of \$8,947. A two-person partnership with the same amount of gross receipts, in contrast, would receive an imputation of \$11,374 because partnerships face more barriers to underreporting compensation (represented by the coefficient on sh2) than do sole proprietorships.

For the "full compliance" imputation, CBO repeated some of the stages in step 1, with modifications. The first-stage probit equation was skipped—an amount was imputed to all sole proprietorships and partnerships. Furthermore, the values of the dummy variables, shx, were set equal to 1 for all firms, even those with fewer than  $x$  owners (to ensure that the underreporting observed among S corporations with fewer than  $x$  owners was not transmitted to partnerships or sole proprietorships). As with the "observed compliance" imputation, CBO applied the parameters of the second-stage linear regression to estimate an amount of labor income. Returning to the simple example, the labor income of the aforementioned sole proprietorship would be \$11,374—the same amount as for the two-person partnership because the underreporting has been disregarded. Finally, the results were adjusted by the third-stage parameters.

## Step 3: Distribute Income from Partnerships to Individual Partners

Because labor income was imputed at the partnership level but the SECA tax is imposed at the individual level, it was necessary to distribute the imputed labor income among the individual partners. In practice, the distribution of partnership income among partners is reported to the IRS and taxpayers on Schedule K-1, which serves the same function for partners as a W-2 does for employees. CBO had access to all Schedule K-1s filed during 2001 and 2004. Among other items, the K-1s include information on a partnership's type of entity, ordinary business income, guaranteed payments, net rental income, and portfolio income.

Imputed labor income from the partnership returns was distributed among the owners listed on a partnership's K-1s in the same proportion as ordinary business income. Then, whenever possible, CBO linked the K-1s to the

individual income tax returns of each owner, making that information available for Step 4 (described below). However, unlike the K-1s, only samples of the tax returns of partnerships and individual taxpayers were available. Because of the way in which partnerships and individuals were sampled, those cases of direct transmission via a K-1 were largely limited to high-income partners of large partnerships.

To ensure that every partner represented in the sample of individual taxpayers received an imputation of labor income, CBO had to attach a value for labor income to every K-1, including those issued by partnerships not included in the SOI Partnership file. That was accomplished by linking the K-1s from each partnership not in the sample to a similar partnership that was in the sample. Partnerships in the sample were deemed similar to those in the unmatched K-1 population on the basis of several factors: number of partners, whether net income was positive or negative, the presence and relative importance of portfolio income, and the presence and relative importance of rental income. CBO then applied the ratio of labor income to net business income from the sampled partnership to the net business income on the unmatched K-1s to derive an estimate of labor income.

Partnerships in the sample were used for that purpose as often as their sampling weight dictated. Thus, if a sampled partnership had a weight of 3 (meaning it represented itself and two unsampled partnerships), it was used to assign amounts of labor income to the K-1s of two unsampled partnerships.<sup>5</sup>

#### **Step 4: Identify Labor Income in the SECA Tax Base**

At this point, all partnership and sole proprietorship income subject to the individual income tax have been associated with an entity type and disaggregated between labor and capital income. However, not all partnership income reported by individual taxpayers is included in the SECA tax base. Furthermore, in the case of a married couple filing a joint income tax return, each

self-employed spouse must file a separate Schedule SE. Therefore, CBO developed a procedure to identify each spouse's partnership and sole proprietorship income that was included in the SECA tax base.

CBO measured the aggregate SECA tax base by using information reported on Schedule SE. On that form, taxpayers report all self-employment income but do not distinguish between income from sole proprietorships and partnerships. The self-employed also file several other forms with their income tax returns, which provide information about the sources of their income:

- Sole proprietors report their net income on Schedule C or, if they are farmers, on Schedule F. The SOI data include information on up to three Schedule Cs and two Schedule Fs but do not identify which spouse was the owner.
- Partners report net income on Schedule E. Although Schedule E does not disaggregate partnership income by spouse, entity type, or pass-through item (that is, proportional shares of business income, guaranteed payments, or rental income)—the information needed to determine whether that income should be reported on Schedule SE—those data were imputed in Step 3.

To identify each business contributing to each spouse's SECA tax base (and the labor income associated with each), CBO had to test various combinations of businesses that potentially produce the income that is reported on each Schedule SE. If, after attributing sole proprietorship income to the SECA tax base, a surplus of potential self-employment income from partnerships remained, then partnership income was added to the SECA tax base in the following order:

1. Any entity type that accounted for at least 85 percent of the tax base,
2. General partnerships,
3. Limited liability partnerships,
4. Limited liability companies,
5. Limited partnerships, and
6. Other partnerships.

5. CBO used the same technique to transmit other information about partnerships to individual partners—specifically, the type of entity, the amounts of specific pass-through items (guaranteed payments and proportional shares of business and rental income), and the capital account potentially eligible for the safe-harbor exclusion.

CBO was able to identify the type of self-employment income on just over 40 percent of Schedule SEs (accounting for 75 percent of the SECA tax base) because combinations of income reported on Schedules C, F, and E matched self-employment income reported on Schedule SE.

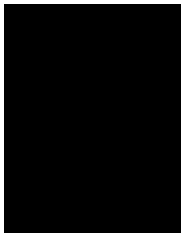
Because not all nonpassive partnership income from Schedule E is reported on Schedule SE, CBO used Schedule K-1s to help determine the source of the self-employment income of taxpayers with partnership income that cannot otherwise be reconciled with Schedule SE. By using amounts from the K-1s to represent income from partnerships instead of the amounts from Schedule E, CBO was able to identify the source of self-employment income (distinguishing between income from sole proprietorships and partnerships) on an

additional 20 percent of Schedule SEs (accounting for an additional 6 percent of the SECA tax base).

CBO could not fully identify the sources of income on the remaining 40 percent of Schedule SEs (accounting for 19 percent of the SECA tax base). Most sources of income could be at least partially identified, however, leaving only 6 percent of the SECA tax base in 2004 that could not be associated with either sole proprietorships or partnerships (that share was 7 percent in 2001). Some of the rest was probably wages earned by clergy, but that share could not be determined.

Using the available data, CBO could not distinguish between general partners and limited partners in a limited partnership. As a result, references to income from limited partnerships in this report include the income of both types of partners.





## Appendix B: Allocating Negative Nonlabor Income Between Labor and Capital

In this analysis, the Congressional Budget Office (CBO) had to allocate self-employment income between labor and capital. CBO assumed that reasonable compensation was a good proxy for labor income (see Appendix A for a description of the methodology used to estimate reasonable compensation for sole proprietorships and partnerships). Any nonlabor income—that is, net business income in excess of reasonable compensation—was attributed to capital. Calculating labor’s share of the Self-Employment Contributions Act (SECA) tax base was then a simple matter of division. For example, if labor income from a limited liability company (LLC) was \$80,000 and capital income was \$20,000, labor’s share was 80 percent. In some cases, however, the imputed reasonable compensation of a business exceeded its reported net income, resulting in negative values for nonlabor income. In those cases, attributing the negative nonlabor income to capital is both theoretically imprecise and difficult to interpret in practice.

Negative nonlabor income is only properly attributable to capital when it reflects real economic losses. For instance, training new employees in advance of an expansion might cause an owner to incur expenses in excess of receipts. A sudden drop in sales could also result in negative capital income. But sometimes, certain provisions in the tax code cause nonlabor income to be negative. For example, the ability of small businesses to expense the cost of equipment (that is, to deduct those costs immediately rather than over the lifetime of an asset) results in net taxable income that is less than economic profits. As a result, nonlabor income may be negative. To the extent that such deductions exceed economic depreciation, they cannot properly be attributed to capital. Finally, taxpayers’ errors undoubtedly explain some of the negative values.

Some of those errors are inadvertent, but others involve the deliberate understatement of receipts or overstatement of expenses. None of that is properly attributed to capital. Unfortunately, identifying the negative nonlabor income that is properly attributed to capital is not possible with available data.

As a more practical matter, attributing negative nonlabor income to capital causes labor’s share of the tax base to exceed 100 percent—a result that is difficult to interpret. For example, if labor income from an LLC is estimated to be \$80,000 but net business income is only \$60,000, then -\$20,000 would be attributed to capital. Under those assumptions, labor’s share of total income would be 133 percent (\$80,000 divided by \$60,000) and capital’s share would be -33 percent.

CBO adopted a rule to avoid that interpretation problem and to minimize unreasonable differences between the Federal Insurance Contributions Act (FICA) and SECA tax bases. For each taxpayer, labor income is summed across all entities and added to the tax base first (conforming to FICA procedures). If total nonlabor income is positive, it is attributed to capital and added to the tax base without any adjustment to labor income. If total nonlabor income is negative, however, labor income is reduced by that amount and nothing is attributed to capital. Applying that rule to the previous example results in \$60,000 of labor income (the original \$80,000 minus the \$20,000 of losses), which is 100 percent of the SECA tax base.

Overall, the only effect of such a rule is to cap labor’s share at 100 percent. The rule has much bigger implications, however, when calculating labor’s share by type of

**Table B-1.**

**Comparing Methods of Calculating Labor’s Share of the Tax Base in the Presence of Negative Nonlabor Income**

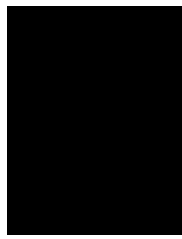
	Income (Dollars)			Labor's Share (Percent)
	Labor	Capital	Total	
<b>Negative Nonlabor Income Is Attributed to Capital of Same Type of Entity</b>				
Sole Proprietorship	40,000	30,000	70,000	57
Limited Liability Company	20,000	-10,000	10,000	200
All Types of Entities	60,000	20,000	80,000	75
<b>Negative Nonlabor Income Offsets Capital Regardless of Type of Entity</b>				
Sole Proprietorship	40,000	20,000	60,000	67
Limited Liability Company	20,000	0	20,000	100
All Types of Entities	60,000	20,000	80,000	75

Source: Congressional Budget Office.

entity. Because negative nonlabor income from one type of entity can offset capital income from a different type, entity types with less negative nonlabor income will have, under CBO’s assumptions, a larger share of labor income (and those with more negative nonlabor income will have a smaller share) than if all nonlabor income was attributed to capital.

The rule also affects the distribution of the overall SECA tax base among entity types. For example, suppose a taxpayer has an interest in two businesses: a sole proprietorship from which he or she derives \$40,000 of labor income and \$30,000 of nonlabor income, and an LLC from which he or she derives \$20,000 of labor income and -\$10,000 of nonlabor income (see Table B-1). If the negative nonlabor income of the LLC is attributed to

capital, the LLC’s contribution to the SECA tax base is also reduced by that amount. As a result, labor’s share of the LLC income is 200 percent. Under CBO’s assumption, the -\$10,000 instead offsets some of the capital income of the sole proprietorship, reducing it from \$30,000 to \$20,000. That change increases labor’s share of the sole proprietorship’s income from 57 percent to 67 percent but reduces labor’s share of the LLC’s income to the cap of 100 percent. It also reduces the sole proprietorship’s contribution to the SECA tax base and increases the LLC’s contribution. If the LLC’s negative nonlabor income exceeded the sole proprietorship’s \$30,000 of capital income, the excess would offset labor income—prorated between entity types—and labor’s share of the SECA tax base would be 100 percent for each entity.



## Appendix C: Description of Tax Organizations' Options for Modifying the SECA Tax Base

**T**his report analyzes three different strategies for making the Self-Employment Contributions Act (SECA) tax base look more like the Federal Insurance Contributions Act (FICA) tax base: a material participation standard for partnerships and limited liability companies (LLCs), a reasonable compensation standard, and a safe-harbor exclusion for capital income. Different combinations of those strategies have been included in options put forth by selected tax organizations: the staff of the Joint Committee on Taxation (JCT), the American Institute of Certified Public Accountants (AICPA), and the American Bar Association's (ABA's) Section of Taxation. The details of each of those options are presented here, along with a brief discussion of how the findings of this Congressional Budget Office (CBO) report apply to the specific combinations presented.

### The Joint Committee on Taxation

In its 2005 volume on options for simplifying the tax code, the JCT staff presented an option with two primary goals: to clarify the treatment of LLC members and reflect the evolving definition of limited partners, and to reduce opportunities for owners of S corporations to avoid FICA taxes by mischaracterizing labor income as capital income.<sup>1</sup> To accomplish those goals, lawmakers could make S corporation owners (but not owners of privately held C corporations) subject to SECA taxes rather than FICA taxes, under the same rules that apply to

partners and LLC members. Those rules would create three classes of partners/owners, each of which would calculate their SECA tax base differently. Which class a partner/owner fell into would depend on his or her level of participation in the firm and the firm's industry, as follows:

- *Nonmaterial participants* would include their reasonable compensation for services rendered to the business;
- *Material participants outside of service industries* would include their guaranteed payments for services rendered plus their proportional share of business income; and
- *Material participants in service industries* would include their guaranteed payments for services rendered, their proportional share of business income, and their proportional share of investment income.<sup>2</sup>

The material participation standard described by the JCT staff is the same one analyzed in this report—that is, the standard applied in the passive loss rules for income tax purposes. JCT's option did not include a safe-harbor exclusion for capital income.

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1. See Joint Committee on Taxation. *Options to Improve Tax Compliance and Reduce Tax Expenditures*, JCS-02-05 (January 27, 2005), p. 95.

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2. The inclusion of investment income was designed to prevent partnerships from using loans and rental arrangements to disguise labor income as investment income. The feature was not considered in this report because it moves the SECA tax farther from the FICA tax rather than closer to it.

In general, CBO's analysis of the material participation standard applies to this option. However, requiring nonmaterial participants to include their reasonable compensation would increase the share of labor income in the SECA tax base (compared with the share under a freestanding material participation standard) and would also mitigate somewhat the loss of revenue.

## The American Institute of Certified Public Accountants

A 1998 proposal from the AICPA is more focused on reducing the amount of capital income in the SECA tax base.<sup>3</sup> It would create two classes of partners and would determine the SECA tax base of each, as follows:

- *Partners contributing less than 100 hours of work during the year* would include their guaranteed payments for services rendered; and
- *Partners contributing 100 or more hours of work during the year* would include their guaranteed payments for services rendered and their proportional share of business income but would subtract an amount representing capital income.

Sole proprietors would also be eligible to claim an exclusion for capital income. The proposed exclusion is more generous than the safe-harbor exclusion analyzed in this report. It would assume a rate of return equal to 150 percent of the highest applicable federal rate, just as the version in this report would, but would apply it to the entire amount of the partner's capital account—that is, all assets reported on Schedule L minus liabilities. That amount would include financial assets that generate interest, dividends, and capital gains—all sources of income

3. American Institute of Certified Public Accountants, "Legislative Proposal Regarding Tax on Self-Employment Income Under Section 1402 of the Internal Revenue Code of 1986" (February 19, 1998).

that are already excluded from the SECA tax base. It would also include items (such as cash) that a sole proprietor could mischaracterize as business assets when they are, in fact, personal assets. Such assets are excluded in the version analyzed in this report.

Because both the material participation standard and the safe harbor for capital in the AICPA's option differ from those analyzed in this report, CBO's findings can be applied only loosely. In CBO's analysis, the material participation standard would increase the shares of both capital and labor income in the SECA tax base, whereas the safe harbor would have the opposite effect. The net effect of combining those two strategies, even for material participants only, is unclear.

## The American Bar Association's Section of Taxation

Unlike the options from JCT and the AICPA, a 2002 proposal by the ABA's Section of Taxation would not explicitly create two or more classes of taxpayers.<sup>4</sup> Instead, it would give partners the choice of excluding from the SECA tax base either their income in excess of reasonable compensation or the safe-harbor amount of capital income described by the AICPA. In principle (although not in the proposed statutory language), sole proprietors would have the same choice.

CBO's findings imply that given a choice between a reasonable compensation standard and a safe harbor for capital, the vast majority of businesses would choose the former. Hence, CBO's analysis of the reasonable compensation standard applies most closely in this case.

4. American Bar Association, Section of Taxation, "Tax Rules Governing Self-Employment Income of Limited Liability Companies and Partnerships" (May 29, 2002), available at [www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2002/020529c.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2002/020529c.authcheckdam.pdf).



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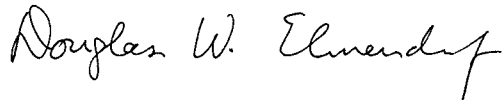
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## About This Document

**T**his Congressional Budget Office (CBO) report was prepared at the request of the former Ranking Member of the Senate Budget Committee. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

Paul Burnham of CBO's Tax Analysis Division wrote the paper under the direction of Frank Sammartino and Janet Holtzblatt. Tom Woodward, formerly of CBO, contributed to the development of the methodology in its early stages. Robert McClelland, Kevin Perese, and Christopher Williams of CBO provided useful comments, as did Susan Nelson of the Office of Tax Analysis in the Department of the Treasury and Laura Kalambokidis of the University of Minnesota. (The assistance of external reviewers implies no responsibility for the final product, which rests solely with CBO.)

Christine Bogusz edited the report, and Maureen Costantino and Jeanine Rees prepared it for publication. An electronic version is available on CBO's Web site ([www.cbo.gov](http://www.cbo.gov)).



Douglas W. Elmendorf  
Director

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