

Gaps between the Net Investment Income Tax Base and the Employment Tax Base

Most high-income taxpayers pay a 3.8 percent tax on income above a threshold (\$200,000 if filing single, \$250,000 if filing joint) either through employment taxes (FICA or SECA) or through the Net Investment Income Tax (NIIT). Some taxpayers, however, are able to avoid this tax on some or all of their business income through gaps in the coverage of employment taxes and NIIT. The Administration's FY17 Budget proposes eliminating these gaps. This paper explains the gaps. It begins with explanations of the taxes involved and discusses how the Budget proposal would fix the problem.

Current Law

The gaps between the employment tax base and the NIIT tax base arise because of differences in tax treatment of the income of pass-through business owners. Table A illustrates these differences in current law and the estimated magnitude of the income falling to specific gaps. The table shows which tax each type of taxpayer faces on various types of income and which sources of income either are simply not covered by any of the three types of taxes or their coverage is uncertain.

FICA. American workers generally are subject to Social Security and Medicare taxes on their wages through Federal Insurance Contributions Act (FICA) taxes, with the employer and the employee each paying half. For 2016, each pays 6.2 percent of wages (a total of 12.4 percent) up to a cap of \$118,500 for Social Security. For Medicare, each pays 1.45 percent (a total of 2.9 percent) on wages with no cap. In addition, taxpayers with wages and self-employment earnings in excess of \$200,000 for a single or head of household return or \$250,000 for a joint return pay an additional 0.9 percent Medicare tax on the excess income. (There is no employer share of this component.) The result is a combined 3.8 percent Medicare tax on wages over the threshold of \$200,000/\$250,000. S corporation shareholders who work for their firms are required to allocate their income between reasonable compensation for services provided to the business and non-wage distributions of profit, and, for shareholders, only the compensation of these owner-employees is subject to FICA taxes. The total tax base for FICA amounted to \$6,475 billion in 2013; of that amount, \$557 billion is currently subject to the 0.9 percent Medicare Surcharge that applies to wages in excess of \$200,000/250,000 (Table A, Column 1, Rows 13 & 14).

SECA. Self-employed individuals pay comparable employment taxes through SECA (Self-Employment Contributions Act) taxes, but they pay the entire tax themselves: 12.4 percent Social Security tax on self-employment earnings up to a cap of \$118,500 for 2016, 2.9 percent Medicare tax on all earnings, and 0.9 percent additional Medicare tax if their earnings exceed the threshold. Self-employed taxpayers take an adjustment against income for half of their SECA taxes (excluding the extra 0.9 percent Medicare tax). Net earnings for SECA purposes generally include earnings from a trade or business carried on as a sole proprietor, independent contractor, or partner.¹ The tax base excludes partnership income from rents (except for rents received in the course of business as a real estate dealer); interest or dividends (unless received in the course of a trade or business as a securities dealer); and capital gains (unless the property is primarily

¹ Section 1402(a).

for sale to customers). The tax base also excludes allocations to limited partners,² except for guaranteed payments received for services provided to the partnership.³ The total tax base for SECA was \$519 billion in 2013, of which \$140 billion was subject to the 0.9 percent Medicare Surcharge on earnings in excess of \$200,000/250,000. (Table A, Column 2, Rows 13 & 14.)

NIIT. Starting in 2013, an individual is subject to a 3.8 percent income tax on the lesser of: (1) net investment income (NII), or (2) the excess of modified adjusted gross income (MAGI)⁴ over a threshold amount. The threshold amount is the same \$200,000/\$250,000 as for the additional Medicare tax on wages and self-employment earnings. NII includes (1) interest, dividends, annuities, royalties, and rents unless derived in the ordinary course of an active trade or business; (2) income from a trade or business that is a passive activity to the taxpayer,⁵ or from a trade or business of trading in financial instruments or commodities; and (3) net gain from the disposition of property held in a trade or business that is a passive activity of the taxpayer or held in a trade or business of trading in financial instruments or commodities.⁶ Net investment income does not include any income subject to employment tax. The total tax base for NIIT (which applies exclusively to income in excess of \$200,000/250,000) was \$434 billion in 2013 (Table A, Column 3, Rows 13 & 14).

The Gaps between the Employment Tax Base and the Investment Income Tax Base

There are four gaps between the tax base for employment taxes and the tax base for the NIIT. These gaps allow some income to escape completely the 3.8 percent tax on income above the \$200,000/\$250,000 thresholds. Table A highlights the sources of business income benefiting from these gaps.

Gap 1. Active S corporation shareholders. S corporation owner-employees are required to pay themselves reasonable compensation for services they provide to the business. They pay FICA taxes on these wages like any other employee, and the S corporation pays the employer's share of these taxes just as for any other employee. However, S corporation owners also generally receive distributions of profits; these amounts are reported to owners on a Schedule K-1 (Form 1120-S). This income is not subject to employment taxes because it is neither wages nor self-employment earnings. It will also not be subject to the NIIT if it is "active S corporation income," that is, income from an activity in which the owner materially participates. Thus, distributions of profits to an S corporation owner who is actively involved in the business are not subject to the 3.8 percent tax under any of the three regimes. As a result, almost 60 percent of the S corporation income paid to active employee-shareholders is excluded from both FICA and NIIT (Table A, Column 7, Row 3).

² Called distributive shares.

³ Section 1402(a)(13)

⁴ MAGI is AGI plus excluded foreign earned income.

⁵ Passive activity is determined by the passive loss rules of Section 469. Participating for more than 500 hours is the most common criterion for being categorized as active versus passive, but additional standards exist. These include materially participating for any five of the previous ten taxable years or for any three prior taxable years if the activity is a personal service activity. Treas. Reg. § 1.469-5T.

⁶ Section 1411(c).

Gap 2. Active limited partners. General and limited partners are not subject to FICA on their partnership income and distributions. While distributions to general partners are subject to SECA, a statutory exception from SECA for limited partners was adopted in 1977. However, the federal tax law does not define “limited partner,” and taxpayers have relied on state law definitions. At the time the exclusion was adopted, state law definitions were largely based on the Uniform Limited Partnership Act of 1916, which essentially restricted the involvement of a limited partner to the role of investor, with little or no ability to manage the business. Over time, the Uniform Limited Partnership Act has been revised to significantly expand the allowable role of limited partners, and states have adopted updated versions of the Act. As a result, many limited partners now take an active role (i.e., materially participate) in running their businesses, and in many states there is little practical difference between general and limited partners. In addition, new business forms have been created, such as limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs), further complicating the issues raised by the absence of a definition of a “limited partner.” As a result, certain limited partners who actively run their businesses can legally avoid both the SECA taxes (because of the statutory exclusion for limited partners) and NIIT taxes (because the partner materially participates in the business). In contrast, limited partners who do not materially participate in their businesses are subject to NIIT on their partnership allocations (Table A, Columns 2 & 3, Rows 6 & 7; Rows 8 & 9).

Gap 3. Sales of business property from active non-trading businesses. Income subject to the NIIT includes the gain on sales of business property if the business is (1) a passive activity of the taxpayer, or (2) the trading of financial instruments or commodities. However, the income from the gains on the sale of business property attributed to owners who actively participate in the business is not subject to the NIIT. As a result, gain from the sale of a given piece of property – for example, an MRI machine used by a radiology practice or a truck used by a construction company – could be subject to NIIT for one set of partners (passive) while not subject to NIIT for their colleagues or competitors who are active (Table A, Column 3, Rows 6 & 7; Rows 8 & 9).

Gap 4. Active LLC members. The application of SECA taxes to members of many limited liability companies (LLCs) is unclear, and some members use the uncertainty to avoid both the NIIT and SECA taxes. Since the first state LLC statute was enacted in 1977, the use of LLCs has grown quickly, and LLCs are now the most common type of business entity taxed as a partnership. In some respects, LLC members look like traditional limited partners. However, the tax code and regulations do not expressly address the treatment of LLC members for employment tax purposes. In 1994 and again in 1997, the IRS and Treasury proposed regulations attempting to clarify the circumstances under which limited partners (including partners in LLPs and LLLPs) and LLC members could qualify for the limited partner exclusion from self-employment taxes.⁷ Congress subsequently imposed a legislative moratorium preventing the IRS from issuing final regulations on the definition of limited partner for SECA

⁷ Among the main provisions of the 1997 proposed regulations, a partner or LLC member who met any of the three following tests (the “three-prong test”) would NOT be considered limited: (i) has personal liability for debts of or claims against the partnership; (ii) has authority to contract on behalf of the partnership; or (iii) participates for more than 500 hours. Also, regardless of the three-pronged test and any other provisions, a service partner in a “service partnership” (health, law, engineering, architecture, accounting, actuarial science or consulting) would not be considered a limited partner.

purposes until after July 1, 1998. Since that time, no relevant legislation has been enacted and no regulations on point have been issued (Table A, Columns 2 & 3, Rows 8 & 9).

While the IRS cannot enforce the proposed 1997 regulations (because they are merely proposed), many taxpayers look to them for determining their self-employment tax obligations.⁸ Sometimes this can contribute to unintended results. For example, some LLC members take the (seemingly inconsistent) positions that they are limited partners for SECA purposes but their participation is sufficiently active that they are not subject to the NIIT. Thus, they avoid both taxes. Specifically, to qualify as a limited partner under the proposed SECA regulations, these owners cannot participate more than 500 hours in their businesses.⁹ Owners of businesses other than service partnerships satisfying this standard would not be subject to self-employment tax on their distributions by virtue of the 1977 exclusion from SECA for limited partners. For NIIT purposes, although they fail the 500-hour prong of the active participation test, they might still claim not to be subject to the NIIT by meeting one of the other standards. For example, these owners might argue that they are not limited partners under the passive loss rules upon which the NIIT turns because the LLC is not formally structured as a limited partnership.¹⁰ Then, if they can meet one of the lower hour thresholds for material participation available to non-limited partners under the passive loss rules,¹¹ they could claim to be exempt from the NIIT by virtue of actively participating in their businesses.¹²

How the FY17 Budget proposal closes the gaps

There are two parts to the FY17 Budget proposal that would rationalize the net investment income and self-employment taxes and close the gaps between them. Columns 4 and 5 of Table A show the affected sources of income.

First, the proposal would amend the definition of net investment income to include gross income and gain from any trades or businesses of an individual that is not otherwise subject to employment taxes. This definition includes the distributions received by active S corporation shareholders, active limited partners, and active LLC members, as well as the proceeds from the sale of business property, regardless of whether the recipient was an active or a passive business owner. The proposal additionally would move the proceeds of the NIIT from the General Fund to the Medicare trust fund, making the NIIT a Medicare tax. These changes would ensure that

⁸ For example, the 1997 proposed regulation's prohibition against a "service partner" being considered a limited partner may help discourage some professionals from claiming limited partner status to avoid SECA. In addition, some states' laws place additional limits on the choice of entity for licensed professionals.

⁹ They must also meet the other two tests for being a "limited partner" under the proposed 1997 SECA regulations. (See note 7 above).

¹⁰ They would thus not meet the definition of a limited partner under the passive loss regulations referenced in note 5 above.

¹¹ Material participation tests under the passive loss rules not available to limited partners include: (1) providing substantially all of the participation in the activity; (2) participating more than 100 hours and as much as anyone else; and (3) participating more than 100 hours if aggregate participation in additional significant activities exceeds 500 hours.

¹² In certain circumstances, partners could consistently claim to be limited partners but still avoid both SECA and NIIT. If they worked less than 500 hours this year, they would fail the SECA limited partner test for material participation under the 1997 proposed regulations. However, if they had materially participated in five of the prior ten taxable years, they would be considered active under the passive loss rules and avoid the NIIT.

all sources of business income of high-income taxpayers are subject to a 3.8 percent tax devoted to the Medicare Trust Fund, either through the NIIT or SECA taxes. This proposal would add \$341 billion to the NIIT base at 2013 levels. (Table A, Column 4, Row 13.)

Second, the proposal would rationalize the self-employment tax treatment of professional services businesses by treating all individual owners of such businesses taxed as S corporations or partnerships in the same manner and to the same degree. Owners providing services who materially participate in the business would be subject to SECA taxes on their distributive shares (with the current exclusion for items such as interest, dividends, rents, and capital gains continuing). Owners who do not materially participate would only be subject to SECA on an amount of income equal to reasonable compensation for services provided. Furthermore, distributions of compensation to owners of professional service S corporations would no longer be treated as wages subject to FICA but as earnings subject to SECA. The result of this change is that for active S corporation owner-employees, self-employment taxes would newly be applied to earnings in excess of the wages deemed to be reasonable compensation. For active members of entities taxed as partnerships (such as LLCs and LPs) who had not been paying self-employment tax, all of their earnings as material participants in the business would be subject to SECA, like their counterparts in general partnerships. This proposal would add \$44 billion to the SECA base at 2013 levels¹³ (Table A, Column 5, Row 13).

Conclusion

Closing the gaps in the definitions of income subject to NIIT and SECA and rationalizing the employment taxation of professional service businesses would improve the equity and efficiency of the tax system. Owners performing comparable functions in their businesses could expect the same taxation regardless of the legal ways they chose to organize their businesses. Ending an opportunity for tax avoidance by high income taxpayers would also improve the perceived and actual fairness of the tax system. Finally, the consistency of employment tax treatment for professional service businesses would remove those taxes as a consideration in the choice of the legal form for all taxpayers in such businesses, not just those at high incomes.

¹³ The intention is to only tax income once. As such, we stack the NIIT proposal first. As a result, the revenue shown in Table A for the SECA proposal reflects only the tax on service partners and S corporation shareholders that are below the NIIT threshold but above the Social Security cap.

TABLE A. Comparison of Coverage by FICA, SECA, & NIIT -- Current Law vs. FY17 Budget Proposals

Tax Year 2013; Dollar Amounts in Billions

Please see attached description for data sources.

	Type of Taxpayer	CURRENT LAW			FY17 BUDGET PROPOSALS			Current Law Tax Coverage = Cols.(1)+(2)+(3) / Col. (6)
		FICA (1)	SECA (2)	NIIT (3)	NIIT Extension (4)	SECA Expansion (5)	Tax Base (Billions) (6)	
(1)	Employee	Wages 5,411					5,411	100%
S-Corporations								
(2)	Employee	Wages 840					840	100%
(3)	Active Shareholder	Wages 224			Allocations; Sale of Business Property 277	Allocations for Prof Serv; Sale of Business Property 28	529	42%
(4)	Passive Shareholder			Allocations 28			28	100%
General Partnerships								
(5)	All Partners		Self-employment 18		Sale of Business Property 3	0	21	86%
Limited Partnerships								
(6)	Active Limited		Self-employment/ Guarant'd paymts ^[1] 11		Allocations; Sale of Business Property 14	Allocations for Prof Serv; Sale of Business Property 4	29	38%
(7)	Passive Limited			Allocations; Sale of Business Property 49			49	100%
Limited Liability Companies, Limited Liability Partnerships and Others								
(8)	Active Member		Self-employment 142		Allocations; Sale of Business Property 47	Allocations for Prof Serv; Sale of Business Property 12	201	71%
(9)	Passive Member			Allocations; Sale of Business Property 91			91	100%
(10)	ALL PARTNERSHIPS^[2]		217	140	64	16	437	82%
(11)	Sole Proprietorships		Profits 302				302	100%
(12)	Investors			Portfolio Income ^[3] 266			266	100%
(13)	2013 BASE	6,475	519	434	341	44	7,767	96%
(14)	Base Over 200K/250K	557	140	434	341		1,472	77%
	Rates	12.4% up to 118.5K ^[4] 2.9% unlimited ^[4] .9% >= 200K/250K	12.4% up to 118.5K ^[5] 2.9% unlimited ^[5] .9% >= 200K/250K	3.8% >= 200K/250K	3.8% >= 200K/250K	12.4% up to 118.5K ^[4] 2.9% unlimited ^[4] Subj. to NIIT expansion: .9% >= 200K/250K		

U.S. Department of the Treasury
Office of Tax Analysis

April 11, 2016

Source: OTA estimates based on IRS Statistics of Income Individual and Partnership Tax Returns, 2013

A: Shaded area indicates not covered by NIIT or SECA/FICA under current law, or treatment uncertain.

B: Active refers to owners who materially participate in the business; Passive refers to owners who do not.

C: Allocations refer to net income of any type that a partnership reports to individual partners.

[1] - Self-employment earnings of limited partners includes guaranteed payments for services.

[2] - The SECA base for partnerships exceeds the sum of self-employment earnings reported by partnerships to their partners. This can be explained in part by netting (individuals generally have either positive or negative SE earnings, but the aggregate figures here are net). In addition, the SECA base includes some income of individuals who are neither sole proprietors nor partners (such as corporate directors).

[3] - Regardless of whether received directly or through an entity

[4] - Includes Employee & Employer Share

[5] - The taxpayer is entitled to deduct a portion of the "employer's" share



Table A Description and Data Sources

The data in the table come from 2013 Statistics of Income files for individuals, S Corporations, and partnerships, with some data matched to administrative tax data. It is important to note that, for the partnerships, while the data from the individual and entity sets provide information on a particular tax event, the data need not agree. The partnership file provides the total that a partnership reports to individual partners with negative allocations subtracted from positive allocations while the individual file reports what an individual claims from all partnerships broken into positive and negative allocations. The Office of Tax Analysis (OTA) uses all information in these data to inform the forecasting models, but the reported totals need not add up to totals reported on one of the forms.

CURRENT LAW:

FICA:

Total: According to the Internal Revenue Service's Tax Year 2013 Individual Statistics of Income (SOI) Complete Report weighted file (SOI Individual file), \$6,475 billion is subject to the FICA tax.¹

S-Corporations: S corporations reported an estimated \$1,064 billion in wages to their employees, of which \$224 billion is compensation paid to owner-employees while wages to non-owner employees is \$840 billion.²

Employees other than of S-corporation: The wages received by employees of entities other than S-Corporations is equal to total wages (\$6,475 billion) net of compensation to S-Corporation owner-employees (\$224 billion) and non-owner employee wages (\$840B). This amount is \$5,411 billion.³

Over \$200,000/\$250,000: Based on data from the SOI Individual file for IRS tax Form 8959, Additional Medicare Tax, \$557 billion is above the NIIT floor (\$200,000/\$250,000) and subject to the additional 0.9% tax.

SECA:

Total: According to Tax Year 2013 SOI Individual file, \$519 billion is subject to the SECA tax.

¹ For further information on these data, see the Tax Year 2013 SOI Individual Income Tax Returns Publication 1304 (Complete Report).

² Estimates are based on matching S-Corporations on the SOI entity files to their K-1s and the K-1 recipients to W-2s issued by the S-Corporation to determine the compensation and W-2 wages paid by S-Corporations to their owner-employees and to their non-owner employees. This matching is not complete as there are situations where either a W-2 or a K-1 is not found for shareholders.

³ This amount may include some of the \$340 billion from the 1120S Schedule A Cost of Labor depending on the recipient of those payments (Sole Proprietorships, S Corporations, C-Corporations, partnerships etc.).

Partnerships: According to the Tax Year 2013 SOI partnership data, the amount of self-employment earnings (SE earnings) allocated to individuals is \$217 billion.⁴

General Partnerships: \$18 billion in individual SE earnings.

Limited Partnerships: \$11 billion in individual SE earnings.

Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs) and Other Partnerships: \$142 billion in individual SE earnings.

Miscellaneous: There is a residual of \$46 billion that is ‘lost’ either through the netting of positive and negative SE earnings or partnerships and arrangements not enumerated in the table. A part of this residual might also be from sources other than those accounted for in the Table.

Sole Proprietorships: According to the Tax Year 2013 SOI Individual file, the amount of SECA dollars attributable to Sole Proprietorships is \$302 billion.

Over \$200,000/\$250,000: According to data from the Additional Medicare Tax form (8959) contained in the Tax Year 2013 SOI Individual file, \$140 billion is above the NIIT floor (\$200,000/\$250,000) and subject to the additional 0.9% tax.

NIIT:

Total: According to Tax Year 2013 SOI Individual file, \$434 billion is subject to the NIIT.

S-Corps: According to Tax Year 2013 SOI Individual file, individuals received \$28 billion in passive net S-Corporation income.

Partnerships: According to the Tax Year 2013 SOI partnership data, the amount of allocations to passive individuals at all income levels is \$140 billion.

Limited Partnerships: Allocations to passive individual investors is \$49 billion.

LLCs, LLPs and Other: Allocations to passive members in LLCs, LLPs and Others is \$91 billion.

Investors: The remaining amount of income subject to the NIIT (\$266B) is allocated to general investors.

PROPOSED LAW:

NIIT:

Total: OTA estimates that \$341 billion in income would be subject to the Administration’s proposed NIIT expansion. This estimate was arrived at using the OTA individual tax calculator.

⁴ For further information on these data, see DeCarlo, Ron, et al., “Partnership Returns, 2012,” Statistics of Income Bulletin, Winter 2015, Volume34, Number 3.

S-Corps: OTA estimates that \$277 billion of active S-Corporation income would be subject to the Administration's proposed NIIT expansion.

Partnerships: OTA estimates that the total allocations to individual partners not already subject to the NIIT or SECA but whose income is above the 200K/250K threshold are \$64 billion.

General Partnerships: \$3 billion in sale of business property.⁵

Limited Partnerships: \$14 billion is attributable to active limited individual partners per the SOI 2013 partnership data.

LLCs, LLPs and Other: \$47 billion is attributable to allocations to active members of LLCs and LLPs.

SECA:

Total: OTA estimates that there is \$44 billion subject to the Administration's proposed SECA expansion.⁶

S-Corps: OTA estimates \$28 billion of active S-Corporation income would be subject to the proposed NIIT expansion.

Partnerships: According to the Tax Year 2013 partnership data, individual allocations in the professional services sectors equaled \$16 billion.

Limited Partnerships: OTA estimates that allocations to active limited partners and their sale of business property totaled \$4 billion.

LLCs, LLPs and Other: Allocations and sale of business property for active members of professional service LLCs and LLPs totaled \$12 billion.

⁵ This total is estimated from the relative size of General Partnerships using available data.

⁶ This total is calculated using information about the percentage of S-Corporations and Partnerships that are 'professional services'.