

# Tax Planning for the Self Employed

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## I. Self Employment Tax-The Forgotten Tax

### A. The Basics

#### 1. Tax Rates

- a) Old Age Survivors & Disability Insurance 12.4%
- b) Hospital Insurance 2.9%

#### 2. Income Subject to Tax

- a) OASDI-reset annually, currently (2004) \$ 87,900
- b) Hospitalization-No maximum

B. Net Earnings from Self Employment includes income and deductions from a trade or business carried on by an individual and from such trade or business to the extent an individual is a partner in a partnership carrying on a trade or business.

1. Pattern of Activity must be continuous and regular as distinguished from occasional action. *Groetzinger SCt 87-1 USTC 9191.*

2. One month labor not continuous or regular *JA Batok 64 TCM 48,709(M). TC Memo 1992-727.*

3. Director's fees taxable if services actually provided based on payments received in expectation of professional business expertise in exchange. *Rev Rul 72-86.* However, contrast

4. Occasional honorariums received for giving speeches not subject to SE tax. *Rev Rul 77-356.*

5. Fiduciary fees received by professional fiduciaries are subject to SE regardless of assets included in estate. Non professional fiduciaries, hired for family or personal relationship, will not be if amount of services involved or assets controlled are small. *Rev Rul 58-5.*

6. Self employment tax limited to amounts actually received for services. Form 1099 in excess of such amounts not controlling. *JM Kawal 72 TCM 1182, Dec. 51,635 (M).*

## II. Partnerships and the SE Tax

A. Distributable share of income to a limited partner excluded from tax §1402(a)(13).

1. Definition of limited partner proposed in January, 1997. Taxpayer Relief Act of 1997 contained a Sense of the Senate statement suggesting that Treasury withdraw the proposed regulations and "Congress should determine the tax law governing self employment income". The Conference agreement prohibited issuing final regulations before July 1, 1998. Hmm...

2. Proposed Definition of a limited partner is done in the negative to exclude a partner that:

a) Is a service partner in a service partnership (health, law, engineering, architecture, accounting, actuarial science or consulting);

b) Has personal liability for debts by reason of being a partner (a G.P.);

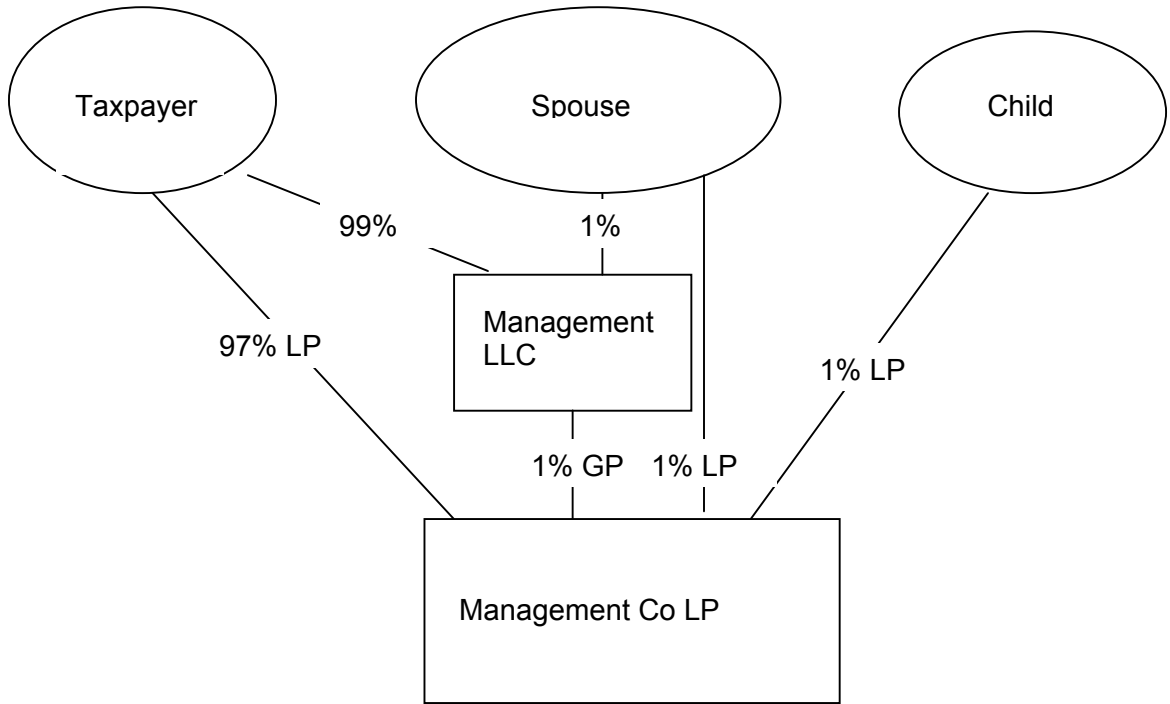
c) Has authority under local law or under the agreement to contract on behalf of the partnership (A Managing Member of an LLC);

d) Works for partnership for more than 500 hours (a G.P. under most local laws);

**(1)** 500 hour rule does not apply to a partner owning a limited partnership interest if limited partners own at least 20% of entity and all limited partners have identical rights

e) Has more than one class of interest unless all limited partners own at least 20% of entity and all limited partners have identical rights (Allows split LP/GP interests in certain circumstances);

Illustration of Use of Proposed Regulations on Limited Partner Definition



B. Distributions to Retiring Partners not subject to SE under Certain Conditions §1402(a)(10):

1. Payments must be made on a periodic basis pursuant to a written plan;
2. The payments must be retirement payments;
3. The retired partner cannot render any services to partnership;
4. The partnership cannot have any obligation to retired partner except for retirement and health benefits;
5. The retired partner's capital account must be paid out in the year before the retirement benefits are made.

C. PLR 200403056 gave approval to a retirement plan used by many professional service firms that allows for:

1. A retirement benefit based on years of service rather than strictly age;
2. Discrimination between classes of partners. Specifically, greater benefits payable earlier with less service were allowed to equity partners vs. contract partners;
3. Payments need not be equal over the life of the program as long as payments are not less than \$100 per month;
4. Payments made in year when any services are provided will not qualify.

III. Other Issues

A. Social Security Protection Act of 2004 exempts self employment income earned in a country which has a totalization agreement with the US even if the other country doesn't require mandatory participation in its plan.

1. Agreements with 20 countries generally provide social tax coverage in country where services are performed unless assignment will last less than five years and services provided to same home country employer or one of its affiliates. Self employment rules allow taxation in country of services.

B. Social Security Protection Act of 2004 also changes SE taxation on sole proprietors income earned in community property states. Prior to

change, all sole proprietor SE income was taxed to husband unless wife exercised substantially all management and control. Law now taxes income to spouse actually carrying on the trade or business.

C. Employment of child not subject to FICA tax. Exemption limited to direct employment of child, not through partnerships. *Rev Rul 70-402*

## Internal Revenue Code

### 1. § 1402 Definitions.

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**(a) Net earnings from self-employment.**

The term “net earnings from self-employment” means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

(1) there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity;

(2) there shall be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate, or other evidence of indebtedness, issued with interest coupons or in registered form by any corporation (including one issued by a government or political subdivision thereof), unless such dividends and interest are received in the course of a trade or business as a dealer in stocks or securities;

(3) there shall be excluded any gain or loss—

(A) which is considered as gain or loss from the sale or exchange of a capital asset,

(B) from the cutting of timber, or the disposal of timber, coal, or iron ore, if section 631 applies to such gain or loss, or

(C) from the sale, exchange, involuntary conversion, or other disposition of property if such property is neither—

(i) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, nor

(ii) property held primarily for sale to customers in the ordinary course of the trade or business;

**(4)** the deduction for net operating losses provided in section 172 shall not be allowed;

**(5)** If—

(A) any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the spouse carrying on such trade or business or, if such trade or business is jointly operated, treated as the gross income and deductions of each spouse on the basis of their respective distributive share of the gross income and deductions; and

(B) any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner;

**(6)** a resident of Puerto Rico shall compute his net earnings from self-employment in the same manner as a citizen of the United States but without regard to section 933 ;

**(7)** the deduction for personal exemptions provided in section 151 shall not be allowed;

**(8)** an individual who is a duly ordained, commissioned, or licensed minister of a church or a member of a religious order shall compute his net earnings from self-employment derived from the performance of service described in subsection (c)(4) without regard to section 107 (relating to rental value of parsonages), section 119 (relating to meals and lodging furnished for the convenience of the employer), and section 911 (relating to citizens or residents of the United States living abroad), but shall not include in such net earnings from self-employment the rental value of any parsonage or any parsonage allowance (whether or not excludable under section 107 ) provided after the individual retires, or any

other retirement benefit received by such individual from a church plan (as defined in section 414(e) ) after the individual retires;

**(9)** the exclusion from gross income provided by section 931 shall not apply;

**(10)** there shall be excluded amounts received by a partner pursuant to a written plan of the partnership, which meets such requirements as are prescribed by the Secretary, and which provides for payments on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, if—

(A) such partner rendered no services with respect to any trade or business carried on by such partnership (or its successors) during the taxable year of such partnership (or its successors), ending within or with his taxable year, in which such amounts were received, and

(B) no obligation exists (as of the close of the partnership's taxable year referred to in subparagraph (A) ) from the other partners to such partner except with respect to retirement payments under such plan, and

(C) such partner's share, if any, of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in subparagraph (A) ;

**(11)** the exclusion from gross income provided by section 911(a)(1) shall not apply;

**(12)** in lieu of the deduction provided by section 164(f) (relating to deduction for one-half of self-employment taxes), there shall be allowed a deduction equal to the product of—

(A) the taxpayer's net earnings from self-employment for the taxable year (determined without regard to this paragraph, and

(B) one-half of the sum of the rates imposed by subsections (a) and (b) of section 1401 for such year;

**(13)** there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services;

**(14)** in the case of church employee income, the special rules of subsection (j)(1) shall apply; and

**(15)** in the case of a member of an Indian tribe, the special rules of section 7873 (relating to income derived by Indians from exercise of fishing rights) shall apply.

If the taxable year of a partner is different from that of the partnership, the distributive share which he is required to include in computing his net earnings from self-employment shall be based on the ordinary income or loss of the partnership for any taxable year of the partnership ending within or with his taxable year. In the case of any trade or business which is carried on by an individual or by a partnership and in which, if such trade or business were carried on exclusively by employees, the major portion of the services would constitute agricultural labor as defined in section 3121(g) —

(i) in the case of an individual, if the gross income derived by him from such trade or business is not more than \$2,400, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be 662/3 percent of such gross income; or

(ii) in the case of an individual, if the gross income derived by him from such trade or business is more than \$2,400 and the net earnings from self-employment derived by him from such trade or business (computed under this subsection without regard to this sentence) are less than \$1,600, the net earnings from self-employment derived by him from such trade or business may, at his option, be deemed to be \$1,600; and

(iii) in the case of a member of a partnership, if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is not more than \$2,400, his distributive share of income described in section 702(a)(8) derived from such trade or business may, at his option, be deemed to be an amount equal to 662/3 percent of his distributive share of such gross income (after such gross income has been so reduced); or

(iv) in the case of a member of a partnership, if his distributive share of the gross income of the partnership derived from such trade or business (after such gross income has been reduced by the sum of all payments to which section 707(c) applies) is more than \$2,400 and his distributive share (whether or not distributed) of income described in section 702(a)(8) derived from such trade or business (computed under this subsection without regard to this sentence) is less than \$1,600, his distributive share of income described in section 702(a)(8) derived from such trade or business may, at his option, be deemed to be \$1,600.

For purposes of the preceding sentence, gross income means—

(v) in the case of any such trade or business in which the income is computed under a cash receipts and disbursements method, the gross receipts from such trade or business reduced by the cost or other basis of property which was purchased and sold in carrying on such trade or business, adjusted (after such reduction) in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of this subsection ; and

(vi) in the case of any such trade or business in which the income is computed under an accrual method, the gross income from such trade or business, adjusted in accordance with the provisions of paragraphs (1) through (7) and paragraph (9) of this subsection ; and, for purposes of such sentence, if an individual (including a member of a partnership) derives gross income from more than one such trade or business, such gross income (including his distributive

share of the gross income of any partnership derived from any such trade or business) shall be deemed to have been derived from one trade or business. The preceding sentence and clauses (i) through (iv) of the second preceding sentence shall also apply in the case of any trade or business (other than a trade or business specified in such second preceding sentence) which is carried on by an individual who is self-employed on a regular basis as defined in subsection (h) , or by a partnership of which an individual is a member on a regular basis as defined in subsection (h) , but only if such individual's net earnings from self-employment as determined without regard to this sentence in the taxable year are less than \$1,600 and less than 66 2/3 percent of the sum (in such taxable year) of such individual's gross income derived from all trades or businesses carried on by him and his distributive share of the income or loss from all trades or businesses carried on by all the partnerships of which he is a member; except that this sentence shall not apply to more than 5 taxable years in the case of any individual, and in no case in which an individual elects to determine the amount of his net earnings from self-employment for a taxable year under the provisions of the two preceding sentences with respect to a trade or business to which the second preceding sentence applies and with respect to a trade or business to which this sentence applies shall such net earnings for such year exceed \$1,600.

**(b) Self-employment income.**

The term “self-employment income” means the net earnings from self-employment derived by an individual (other than a nonresident alien individual, except as provided by an agreement under section 233 of the Social Security Act) during any taxable year; except that such term shall not include—

(1) in the case of the tax imposed by section 1401(a) , that part of the net earnings from self-employment which is in excess of (i) an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which such taxable year begins, minus (ii) the amount of the wages paid to such individual during such taxable years; or

(2) the net earnings from self-employment, if such net earnings for the taxable year are less than \$400.

For purposes of paragraph (1) , the term “wages” (A) includes such remuneration paid to an employee for services included under an agreement entered into pursuant to the provisions of section 3121(l) (relating to coverage of citizens of the United States who are employees of foreign affiliates of American employers), as would be wages under section 3121(a) if such services constituted employment under section 3121(b) , and (B) includes compensation which is subject to the tax imposed by section 3201 or 3211 . An individual who is not a citizen of the United States but who is a resident of the Commonwealth of Puerto Rico, the Virgin Islands, Guam, or American Samoa shall not, for purposes of this chapter be considered to be a nonresident alien individual. In the case of church employee income, the special rules of subsection (j)(2) shall apply for purposes of paragraph (2) .

**(c) Trade or business.**

The term “trade or business”, when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses), except that such term shall not include—

(1) the performance of the functions of a public office, other than the functions of a public office of a State or a political subdivision thereof with respect to fees received in any period in which the functions are performed in a position compensated solely on a fee basis and in which such functions are not covered under an agreement entered into by such State and the Commissioner of Social Security pursuant to section 218 of the Social Security Act;

(2) the performance of service by an individual as an employee, other than—

(A) service described in section 3121(b)(14)(B) performed by an individual who has attained the age of 18,

(B) service described in section 3121(b)(16) ,

(C) service described in section 3121(b)(11) , (12) , or (15) performed in the United States (as defined in section 3121(e)(2) ) by a citizen of the United States, except service which constitutes “employment” under section 3121(y) ,

(D) service described in paragraph (4) of this subsection ,

(E) service performed by an individual as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis with respect to fees received in any period in which such service is not covered under an agreement entered into by such State and the Commissioner of Social Security pursuant to section 218 of the Social Security Act,

(F) service described in section 3121(b)(20) , and

(G) service described in section 3121(b)(8)(B) ;

(3) the performance of service by an individual as an employee or employee representative as defined in section 3231 ;

(4) the performance of service by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order;

(5) the performance of service by an individual in the exercise of his profession as a Christian Science practitioner; or

(6) the performance of service by an individual during the period for which an exemption under subsection (g) is effective with respect to him.

The provisions of paragraph (4) or (5) shall not apply to service (other than service performed by a member of a religious order who has taken a vow of poverty as a member of such order) performed by an individual unless an exemption under subsection (e) is effective with respect to him.

**(d) Employee and wages.**

The term “employee” and the term “wages” shall have the same meaning as when used in chapter 21 ( sec. 3101 and following, relating to Federal Insurance Contributions Act).

**(e) Ministers, members of religious orders, and Christian Science practitioners.**

**(1) Exemption.**

Subject to paragraph (2) , any individual who is (A) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (B) a Christian Science practitioner, upon filing an application (in such form and manner, and with such official, as may be prescribed by regulations made under this chapter) together with a statement that either he is conscientiously opposed to, or because of religious principles he is opposed to, the acceptance (with respect to services performed by him as such minister, member, or practitioner) of any public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act) and, in the case of an individual described in subparagraph (A) , that he has informed the ordaining, commissioning, or licensing body of the church or order that he is opposed to such insurance, shall receive an exemption from the tax imposed by this chapter with respect to services performed by him as such minister, member, or practitioner.

Notwithstanding the preceding sentence, an exemption may not be granted to an individual under this subsection if he had filed an effective waiver certificate under this section as it was in effect before its amendment in 1967.

**(2) Verification of application.**

The Secretary may approve an application for an exemption filed pursuant to paragraph (1) only if the Secretary has verified that the individual applying for the exemption is aware of the grounds on which the individual may receive an exemption pursuant to this subsection and that the individual seeks exemption on such grounds. The Secretary (or

the Commissioner of Social Security under an agreement with the Secretary) shall make such verification by such means as prescribed in regulations.

**(3) Time for filing application.**

Any individual who desires to file an application pursuant to paragraph (1) must file such application on or before whichever of the following dates is later: (A) the due date of the return (including any extension thereof) for the second taxable year for which he has net earnings from self-employment (computed without regard to subsections (c)(4) and (c)(5) of \$400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5) ; or (B) the due date of the return (including any extension thereof) for his second taxable year ending after 1967.

**(4) Effective date of exemption.**

An exemption received by an individual pursuant to this subsection shall be effective for the first taxable year for which he has net earnings from self-employment (computed without regard to subsection (c)(4) and (c)(5) ) of \$400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5) , and for all succeeding taxable years. An exemption received pursuant to this subsection shall be irrevocable.

**(f) Partner's taxable year ending as the result of death.**

In computing a partner's net earnings from self-employment for his taxable year which ends as a result of his death (but only if such taxable year ends within, and not with, the taxable year of the partnership), there shall be included so much of the deceased partner's distributive share of the partnership's ordinary income or loss for the partnership taxable year as is not attributable to an interest in the partnership during any period beginning on or after the first day of the first calendar month following the month in which such partner died. For purposes of this subsection—

(1) in determining the portion of the distributive share which is attributable to any period specified in the preceding sentence, the ordinary income or loss of the partnership shall be treated as having been realized or sustained ratably over the partnership taxable year; and

(2) the term “deceased partner's distributive share” includes the share of his estate or of any other person succeeding, by reason of his death, to rights with respect to his partnership interest.

**(g) Members of certain religious faiths.**

**(1) Exemption.**

Any individual may file an application (in such form and manner, and with such official, as may be prescribed by regulations under this chapter) for an exemption from the tax imposed by this chapter if he is a member of a recognized religious sect or division thereof and is an adherent of

established tenets or teachings of such sect or division by reason of which he is conscientiously opposed to acceptance of the benefits of any private or public insurance which makes payments in the event of death, disability, old-age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act). Such exemption may be granted only if the application contains or is accompanied by—

(A) such evidence of such individual's membership in, and adherence to the tenets or teachings of, the sect or division thereof as the Secretary may require for purposes of determining such individual's compliance with the preceding sentence, and

(B) his waiver of all benefits and other payments under titles II and XVIII of the Social Security Act on the basis of his wages and self-employment income as well as all such benefits and other payments to him on the basis of the wages and self-employment income of any other person,

and only if the Commissioner of Social Security finds that—

(C) such sect or division thereof has the established tenets or teachings referred to in the preceding sentence,

(D) it is the practice, and has been for a period of time which he deems to be substantial, for members of such sect or division thereof to make provision for their dependent members which in his judgment is reasonable in view of their general level of living, and

(E) such sect or division thereof has been in existence at all times since December 31, 1950.

An exemption may not be granted to any individual if any benefit or other payment referred to in subparagraph (B) became payable (or, but for section 203 or 222(b) of the Social Security Act, would have become payable) at or before the time of the filing of such waiver.

**(2) Period for which exemption effective.**

An exemption granted to any individual pursuant to this subsection shall apply with respect to all taxable years beginning after December 31, 1950, except that such exemption shall not apply for any taxable year—

(A) beginning (i) before the taxable year in which such individual first met the requirements of the first sentence of paragraph (1), or (ii) before the time as of which the Commissioner of Social Security finds that the sect or division thereof of which such

individual is a member met the requirements of subparagraphs (C) and (D) , or

(B) ending (i) after the time such individual ceases to meet the requirements of the first sentence of paragraph (1) , or (ii) after the time as of which the Commissioner of Social Security finds that the sect or division thereof of which he is a member ceases to meet the requirements of subparagraph (C) or (D) .

**(3) Subsection to apply to certain church employees.**

This subsection shall apply with respect to services which are described in subparagraph (B) of section 3121(b)(8) (and are not described in subparagraph (A) of such section).

**(h) Regular basis.**

An individual shall be deemed to be self-employed on a regular basis in a taxable year, or to be a member of a partnership on a regular basis in such year, if he had net earnings from self-employment, as defined in the first sentence of subsection (a) , of not less than \$400 in at least two of the three consecutive taxable years immediately preceding such taxable year from trades or businesses carried on by such individual or such partnership.

**(i) Special rules for options and commodities dealers.**

**(1) In general.**

Notwithstanding subsection (a)(3)(A) , in determining the net earnings from self-employment of any options dealer or commodities dealer, there shall not be excluded any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from section 1256 contracts or property related to such contracts.

**(2) Definitions.**

For purposes of this subsection —

(A) Options dealer. The term “options dealer” has the meaning given such term by section 1256(g)(8) .

(B) Commodities dealer. The term “commodities dealer” means a person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission.

(C) Section 1256 contracts. The term “ section 1256 contract” has the meaning given to such term by section 1256(b) .

**(j) Special rules for certain church employee income.**

**(1) Computation of net earnings.**

In applying subsection (a) —

(A) church employee income shall not be reduced by any deduction;

(B) church employee income and deductions attributable to such income shall not be taken into account in determining the amount of other net earnings from self-employment.

**(2) Computation of self-employment income.**

(A) Separate application of subsection (b)(2) . Paragraph (2) of subsection (b) shall be applied separately—

(i) to church employee income, and

(ii) to other net earnings from self-employment.

(B) \$100 floor. In applying paragraph (2) of subsection (b) to church employee income, “\$100” shall be substituted for “\$400”.

**(3) Coordination with subsection (a)(12) .**

Paragraph (1) shall not apply to any amount allowable as a deduction under subsection (a)(12) , and paragraph (1) shall be applied before determining the amount so allowable.

**(4) Church employee income defined.**

For purposes of this section , the term “church employee income” means gross income for services which are described in section 3121(b)(8)(B) (and are not described in section 3121(b)(8)(A) ).

**(k) Codification of treatment of certain termination payments received by former insurance salesmen.**

Nothing in subsection (a) shall be construed as including in the net earnings from self-employment of an individual any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if—

(1) such amount is received after termination of such individual's agreement to perform such services for such company,

(2) such individual performs no services for such company after such termination and before the close of such taxable year,

(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

(4) the amount of such payment—

(A) depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and

(B) does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).

**SUPREME COURT OF THE UNITED STATES**

**COMMISSIONER OF INTERNAL REVENUE, Petitioner v. ROBERT P. GROETZINGER,**

Respondent.

Docket: 85-1226

Filed February 24, 1987

SYLLABUS

Certiorari To The United States Court Of Appeals For The Seventh Circuit

For most of 1978, respondent devoted 60 to 80 hours per week to parimutuel wagering on dog races with a view to earning a living from such activity, had no other employment, and gambled solely for his own account. His efforts generated gross winnings of \$70,000 on bets of \$72,032, for a net gambling loss for the year of \$2,032. Although he reported this loss on his 1978 tax return, he did not utilize it in computing his adjusted gross income or claim it as a deduction. Upon audit, the Commissioner of Internal Revenue determined that, under the Internal Revenue Code of 1954 (Code) as it existed in 1978, respondent was subject to a minimum tax because part of the gambling loss deduction to which he was entitled was an "item of tax preference." Under the Code, such items could be lessened by certain deductions that were "attributable to a trade or business carried on by the taxpayer." In redetermining respondent's tax deficiency, the Tax Court held that he was in the "trade or business" of gambling, so that no part of his gambling losses were an item of tax preference subjecting him to a minimum tax for 1978. The Court of Appeals affirmed.

Held: A full-time gambler who makes wagers solely for his own account is engaged in a "trade or business" within the meaning of Code sections 162(a) and 62(1).

771 F.2d 269, affirmed.

OPINION

BLACKMUN, J., delivered the opinion of the Court, in which BRENNAN, MARSHALL, POWELL, STEVENS, and O'CONNOR, JJ., joined. WHITE, J., filed a dissenting opinion, in which REHNQUIST, C.J., and SCALIA, J., joined.

The issue in this case is whether a full-time gambler who makes wagers solely for his own account is engaged in a "trade or business," within the meaning of section section 162(a) and 62(1) of the Internal Revenue Code of 1954, as amended, 26 U.S.C. sections 162(a) and 62(1). <<ENDNOTE 1>> The tax year with which we here are concerned is the calendar year 1978; technically, then, we look to the Code as it read at that time.

I.

There is no dispute as to the facts. The critical ones are stipulated. See App. 9. Respondent Robert P. Groetzinger had worked for 20 years in sales and market research for an Illinois manufacturer when his position was terminated in February 1978. During the remainder of that year, respondent busied himself with parimutuel wagering, primarily on greyhound races. He gambled at tracks in Florida and Colorado. He went to the track 6 days a week for 48 weeks in 1978. He spent a substantial amount of time studying racing forms, programs, and other materials. He devoted from 60 to 80 hours each week to these gambling-related endeavors. He never placed bets on behalf of any other person, or sold tips, or collected commissions for placing bets, or functioned as a bookmaker. He gambled solely for his own account. He had no other profession or type of employment. <<ENDNOTE 2>>

Respondent kept a detailed accounting of his wagers and every day noted his winnings and losses in a record book. In 1978, he had gross winnings of \$70,000, but he bet \$72,032; he thus realized a net gambling loss for the year of \$2,032.

Respondent received \$6,498 in income from other sources in 1978. This came from interest, dividends, capital gains, and salary earned before his job was terminated.

On the federal income tax return he filed for the calendar year 1978 respondent reported as income only the \$6,498 realized from nongambling sources. He did not report any gambling winnings or deduct any gambling losses. <<ENDNOTE 3>> He did not itemize deductions. Instead, he computed his tax liability from the tax tables.

Upon audit, the Commissioner of Internal Revenue determined that respondent's \$70,000 in gambling winnings were to be included in his gross income and that, pursuant to section 165(d) of the Code, 26 U.S.C. section 165(d), a deduction was to be allowed for his gambling losses to the extent of these gambling gains. But the Commissioner further determined that, under the law as it was in 1978, a portion of respondent's \$70,000 gambling-loss deduction was an item of tax preference and operated to subject him to the minimum tax under section 56(a) of the Code, 26 U.S.C. section 56(a) (1976 ed.). At that time, under statutory provisions in effect from 1976 until 1982, "items of tax preference" were lessened by certain deductions, but not by deductions not "attributable to a trade or business carried on by the taxpayer." sections 57(a)(1) and (b)(1)(A), and

section 62(1), 26 U.S.C. sections 57(a)(1) and (b)(1)(A), and section 62(1) (1976 ed. and Supp. I). <<ENDNOTE 4>>

These determinations by the Commissioner produced a section 56(a) minimum tax of \$2,142 and, with certain other adjustments not now in dispute, resulted in a total asserted tax deficiency of \$2,522 for respondent for 1978.

Respondent sought redetermination of the deficiency in the United States Tax Court. That court, in a reviewed decision, with only two judges dissenting, held that respondent was in the trade or business of gambling, and that, as a consequence, no part of his gambling losses constituted an item of tax preference in determining any minimum tax for 1978. 82 T.C. 793 (1984). In so ruling, the court adhered to its earlier court-reviewed decision in *Ditunno v. Commissioner*, 80 T.C. 362 (1983). The court in *Ditunno*, *id.*, at 371, had overruled *Gentile v. Commissioner*, 65 T.C. 1 (1975), a case where it had rejected the Commissioner's contention (contrary to his position here) that a full-time gambler was in a trade or business and therefore was subject to self-employment tax.

The United States Court of Appeals for the Seventh Circuit affirmed. 771 F.2d 269 (1985). Because of a conflict on the issue among the Courts of Appeals, <<ENDNOTE 5>> we granted certiorari. \_\_\_\_ U.S. \_\_\_\_ (1986).

## II.

The phrase "trade or business" has been in section 162(a) and in that section's predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations. The slightly longer phrases, "carrying on a trade or business" and "engaging in a trade or business," themselves are used no less than 60 times in the Code. The concept thus has a well-known and almost constant presence on our tax-law terrain. Despite this, the Code has never contained a definition of the words "trade or business" for general application, and no regulation has been issued expounding its meaning for all purposes. <<ENDNOTE 6>> Neither has a broadly applicable authoritative judicial definition emerged. <<ENDNOTE 7>> Our task in this case is to ascertain the meaning of the phrase as it appears in the sections of the Code with which we are here concerned. <<ENDNOTE 8>>

In one of its early tax cases, *Flint v. Stone Tracy Co.*, 220 U.S. 107-1 (1911), the Court was concerned with the Corporation Tax imposed by the Tariff Act of 1909, 36 Stat., ch. 6, 11, 112-117, and the status of being engaged in business. It said: "'Business' is a very comprehensive term and embraces everything about which a person can be employed." 220 U.S., at 171. It embraced the Bouvier Dictionary definition: "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit." *Ibid.* See also *Helvering v. Horst*, 311 U.S. 112, 1181 (1940). And Justice Frankfurter has observed that "we assume that Congress uses common

words in their popular meaning, as used in the common speech of men." Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Colum. L. Rev. 527, 536 (1947).

With these general comments as significant background, we turn to pertinent cases decided here. *Snyder v. Commissioner*, 295 U.S. 134 (1935), had to do with margin trading and capital gains, and held, in that context, that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. Justice Brandeis, in his opinion for the Court, noted that the Board of Tax Appeals theretofore had ruled that a taxpayer who devoted the major portion of his time to transactions on the stock exchange for the purpose of making a livelihood could treat losses incurred as having been sustained in the course of a trade or business. He went on to observe that no facts were adduced in *Snyder* to show that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.'" *Id.*, at 139. These observations, thus, are dicta, but, by their use, the Court appears to have drawn a distinction between an active trader and an investor.

In *Deputy v. duPont*, 308 U.S. 488 (1940), the Court was concerned with what were "ordinary and necessary" expenses of a taxpayer's trade or business, within the meaning of section 23(a) of the Revenue Act of 1928, 45 Stat. 799. In ascertaining whether carrying charges on short sales of stock were deductible as ordinary and necessary expenses of the taxpayer's business, the Court assumed that the activities of the taxpayer in conserving and enhancing his estate constituted a trade or business, but nevertheless disallowed the claimed deductions because they were not "ordinary" or "necessary." 308 U.S., at 493-497. Justice Frankfurter, in a concurring opinion joined by Justice Reed, did not join the majority. He took the position that whether the taxpayer's activities constituted a trade or business was "open for determination," *id.*, at 499, and observed:

"... carrying on any trade or business,' within the contemplation of section 23(a), involves holding one's self out to others as engaged in the selling of goods or services. This the taxpayer did not do. . . . Without elaborating the reasons for this construction and not unmindful of opposing considerations, including appropriate regard for administrative practice, I prefer to make the conclusion explicit instead of making the hypothetical litigation-breeding assumption that this taxpayer's activities, for which expenses were sought to be deducted, did constitute a 'trade or business.'" *Ibid.*

Next came *Higgins v. Commissioner*, 312 U.S. 212 (1941). There the Court, in a bare and brief unanimous opinion, ruled that salaries and other-expenses incident to looking after one's own investments in bonds and stocks were not deductible under section 23(a) of the Revenue Act of 1932, 47 Stat. 179, as expenses paid or incurred in carrying on a trade or business. While surely cutting back on Flint's broad approach, the Court seemed to do little more than announce that since 1918 "the present form

[of the statute] was fixed and has so continued"; that "[n]o regulation has ever been promulgated which interprets the meaning of 'carrying on a business'"; that the comprehensive definition of "business" in Flint was "not controlling in this dissimilar inquiry"; that the facts in each case must be examined; that not all expenses of every business transaction are deductible; and that "[n]o matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board." 312 U.S., at 215-218. The opinion, therefore, -- although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business -- must stand for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business," and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business. <<ENDNOTE 9>> See also *United States v. Gilmore*, 372 U.S. 39, 44-45 (1963); *Whipple v. Commissioner*, 373 U.S. 193 (1963). It is of interest to note that, although Justice Frankfurter was on the Higgins Court and this time did not write separately, and although Justice Reed, who had joined the concurring opinion in *duPont*, was the author of the Higgins opinion, the Court in that case did not even cite *duPont* and thus paid no heed whatsoever to the content of Justice Frankfurter's pronouncement in his concurring opinion. <<ENDNOTE 10>> Adoption of the Frankfurter gloss obviously would have disposed of the case in the Commissioner's favor handily and automatically, but that easy route was not followed.

Less than three months later, the Court considered the issue of the deductibility, as business expenses, of estate and trust fees. In unanimous opinions issued the same day and written by Justice Black, the Court ruled that the efforts of an estate or trust in asset conservation and maintenance did not constitute a trade or business. *City Bank Farmers Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127 (1941). The Higgins case was deemed to be relevant and controlling. Again, no mention was made of the Frankfurter concurrence in *duPont*. Yet Justices Reed and Frankfurter were on the Court.

*Snow v. Commissioner*, 416 U.S. 500 (1974), concerned a taxpayer who had advanced capital to a partnership formed to develop an invention. On audit of his 1966 return, a claimed deduction under section 174(a)(1) of the 1954 Code for his pro rata share of the partnership's operating loss was disallowed. The Tax Court and the Sixth Circuit upheld that disallowance. This Court reversed. Justice Douglas, writing for the eight Justices who participated, observed: "Section 174 was enacted in 1954 to dilute some of the conception of 'ordinary and necessary' business expenses under section 162(a) (then section 23(a)(1) of the Internal Revenue Code of 1939) adumbrated by Mr. Justice Frankfurter in a concurring opinion in *Deputy v. duPont* . . . where he said that the section in question . . . 'involves holding one's self out to others as engaged in the selling of goods or services.'" 416 U.S., at 502-503. He went on to state, *id.*, at 503, that section 162(a) "is more narrowly written than is section 174."

From these observations and decisions, we conclude (1) that, to be sure, the statutory words are broad and comprehensive (Flint); (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business (Higgins; City Bank; Pyne); (3) that the opposite conclusion may follow for an active trader (Snyder); (4) that Justice Frankfurter's attempted gloss upon the decision in duPont was not adopted by the Court in that case; (5) that the Court, indeed, later characterized it as an "adumbration" (Snow); and (6) that the Frankfurter observation, specifically or by implication, never has been accepted as law by a majority opinion of the Court, and more than once has been totally ignored. We must regard the Frankfurter gloss merely as a two-Justice pronouncement in a passing moment, and, while entitled to respect, as never having achieved the status of a Court ruling. One also must acknowledge that Higgins, with its stress on examining the facts in each case, affords no readily helpful standard, in the usual sense, with which to decide the present case and others similar to it. The Court's cases, thus, give us results, but little general guidance.

### III.

Federal and state legislation and court decisions, perhaps understandably, until recently have not been noticeably favorable to gambling endeavors and even have been reluctant to treat gambling on a parity with more "legitimate" means of making a living. See, e.g., sections 4401 et seq. of the Code; *Marchetti v. United States*, 390 U.S. 39, 44-46, and nn. 5 and 6 (1968). <<ENDNOTE 11>> And the confinement of gambling-loss deductions to the amount of gambling gains, a provision brought into the income tax law as section 23(g) of the Revenue Act of 1934, 48 Stat. 689, and carried forward into section 165(d) of the 1954 Code, closed the door on suspected abuses, see H.R. Rep. No. 704, 73d Cong., 2d Sess., 22 (1934); S. Rep. No. 558, 73d Cong., 2 Sess., 25 (1934), but served partially to differentiate genuine gambling losses from many other types of adverse financial consequences sustained during the tax year. Gambling winnings, however, have not been isolated from gambling losses. The Congress has been realistic enough to recognize that such losses do exist and do have some effect on income, which is the primary focus of the federal income tax.

The issue this case presents has "been around" for a long time and, as indicated above, has not met with consistent treatment in the Tax Court itself or in the Federal Courts of Appeals. The Seventh Circuit, in the present case, said the issue "has proven to be most difficult and troublesome over the years." 771 F.2d, at 271. The difficulty has not been ameliorated by the persistent absence of an all-purpose definition, by statute or regulation, of the phrase "trade or business" which so frequently appears in the Code. Of course, this very frequency well may be the explanation for legislative and administrative reluctance to take a position as to one use that might affect, with confusion, so many others.

Be that as it may, this taxpayer's case must be decided and, from what we have outlined above, must be decided in the face of a decisional history that is not positive or even fairly indicative, as we read the cases, of what the result should be. There are, however, some helpful indicators.

If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.

It is argued, however, that a full-time gambler is not offering goods or his services, within the line of demarcation that Justice Frankfurter would have drawn in *duPont*. Respondent replies that he indeed is supplying goods and services, not only to himself but, as well, to the gambling market; thus, he says, he comes within the Frankfurter test even if that were to be imposed as the proper measure. "It takes two to gamble." Brief for Respondent 3. Surely, one who clearly satisfies the Frankfurter adumbration usually is in a trade or business. But does it necessarily follow that one who does not satisfy the Frankfurter adumbration is not in a trade or business? One might well feel that a full-time gambler ought to qualify as much as a full-time trader, <<ENDNOTE 12>> as Justice Brandeis in *Snyder* implied and as courts have held. <<ENDNOTE 13>> The Commissioner, indeed, accepts the trader result. Tr. of Oral Arg. 17. In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.

We are not satisfied that the Frankfurter gloss would add any helpful dimension to the resolution of cases such as this one, or that it provides a "sensible test," as the Commissioner urges. See Brief for Petitioner 36. It might assist now and then, when the answer is obvious and positive, but it surely is capable of breeding litigation over the meaning of "goods," the meaning of "services," or the meaning of "holding one's self out." And we suspect that -- apart from gambling -- almost every activity would satisfy the gloss. <<ENDNOTE 14>> A test that everyone passes is not a test at all. We therefore now formally reject the Frankfurter gloss which the Court has never adopted anyway.

Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with . . . business or trade," on the other. See Revenue Act of 1916, section 5(a) Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of

trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 197 (1963). We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

It is suggested that we should defer to the position taken by the Commissioner and by the Solicitor General, but, in the absence of guidance, for over several decades now, through the medium of definitive statutes or regulations, we see little reason to do so. We would defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business. Otherwise, as here, in the context of a minimum tax, it is not too extreme to say that the taxpayer is being taxed on his gambling losses, <<ENDNOTE 15>> a result distinctly out of line with the Code's focus on income.

We do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzing satisfied that test in 1978. Constant and large-scale effort on his part was made. Skill was required and was applied. He did what he did for a livelihood, though with a less than successful result. This was not a hobby or a passing fancy or an occasional bet for amusement.

We therefore adhere to the general position of the *Higgins* Court, taken 45 years ago, that resolution of this issue "requires an examination of the facts in each case." 312 U.S., at 217. This may be thought by some to be a less-than-satisfactory solution, for facts vary. See Boyle, *What is a Trade or Business?*, 39 *Tax Lawyer* 737, 767 (1986); Note, *The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers*, 38 *Tax Lawyer* 759 (1985); Lopez, *Defining "Trade of Business" under the Internal Revenue Code: A Survey of Relevant Cases*, 11 *Fla. St. L. Rev.* 949 (1984). Cf. Comment, *Continuing Vitality of the "Goods or Services" Test*, 15 *U. Balt. L. Rev.* 108 (1985). But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests. Cf. *Flood v. Kuhn*, 407 U.S. 258, 269-285 (1972). <<ENDNOTE 16>>

The judgment of the Court of Appeals is affirmed.

It is so ordered.

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Justice WHITE, with whom The Chief Justice and Justice SCALIA join, dissenting.

The 1982 amendments to the Tax Code made clear that gambling is not a trade or business. Under those amendments, the alternative minimum tax base equals adjusted gross income reduced by specified amounts, including gambling losses, and increased by items not relevant here. See 26 U.S.C. sections 55(b), 55(e)(1)(A), 165(d) (1982 ed. and Supp. III). <<ENDNOTE 1>> If full-time gambling were a trade or business, a full-time gambler's gambling losses would be "deductions . . . attributable to a trade or business carried on by the taxpayer," and hence deductible from gross income in computing adjusted gross income, 26 U.S.C. section 62((1), though only to the extent of gambling winnings, 26 U.S.C. section 165(d). To again subtract gambling losses (to the extent of gambling winnings) from adjusted gross income when computing the alternative minimum tax base would be to give the full-time gambler a double deduction for alternative minimum tax purposes, which was certainly not Congress' intent. <<ENDNOTE 2>> Thus, when Congress amended the alternative minimum tax provisions in 1982, it implicitly accepted the teaching of *Gentile v. Commissioner*, 65 T.C. 1 (1975), that gambling is not a trade or business. <<ENDNOTE 3>> Groetzinger would have had no problem under the 1982 amendments.

One could argue, I suppose, that although gambling is not a trade or business under the 1982 amendments, it was in 1978, the tax year at issue here. But there is certainly no indication that Congress intended in 1982 to alter the status of gambling as a trade or business. Rather, Congress was correcting an inequity that had arisen because gambling is not a trade or business, just as 40 years earlier Congress had, by enacting the predecessor to 26 U.S.C. section 212, corrected an inequity that became apparent when this Court held that a full-time investor is not engaged in a trade or business. See *Higgins v. Commissioner*, 312 U.S. 212 (1941). In neither case did Congress attempt to alter the then-prevailing definition of trade or business, nor do I think this Court should do so now to avoid a harsh result in this case. <<ENDNOTE 4>> In any event the Court should recognize that its holding is a sport that applies only to a superseded statute and not to the tax years governed by the 1982 amendments. Accordingly, I dissent.

<<ENDNOTES -- MAJORITY OPINION>>

1/ All references herein to the Internal Revenue Code are, unless otherwise described, to the 1954 Code, not to the Internal Revenue Code of 1986, as it has been designated by section 2(a) of the Tax Reform Act of 1986, \_\_\_\_ Stat. \_\_\_\_.

2/ The Tax Court put it this way: "It is not disputed that petitioner during 1978 was engaged full-time in parimutuel wagering on dog races, had

no other employment during that period, gambled solely for his own account, and devoted an extraordinary amount of time and effort to his gambling with a view to earning a living from such activity." 82 T.C. 793, 796 (1984).

3/ Respondent, however, did report his net gambling loss of \$2,032 in Schedule E (Supplemental Income Schedule) of his return, but he did not utilize that amount in computing his adjusted gross income or claim it as an itemized deduction.

4/ This statutory scheme was amended by the Tax Equity and Fiscal Responsibility Act of 1982, section 201(a), 96 Stat. 411. For tax years after 1982, gambling-loss deductions explicitly are excluded from the minimum tax base. The Commissioner acknowledges that a taxpayer like respondent for a year after 1982 would not be subject to minimum tax liability because of his gambling-loss deduction. Brief for Petitioner 4, n. 4.

5/ Compare *Nipper v. Commissioner*, 746 F.2d 813 (CA11 1984), affg, without opinion, 47 TCM 136, paragraph 83,644 P-H Memo TC (1983), and the Seventh Circuit's decision in the present case, with *Gajewski v. Commissioner*, 723 F.2d 1062 (CA2 1983), cert. denied, 469 U.S. 818 (1984); *Estate of Cull v. Commissioner*, 746 F.2d 1148 (CA6 1984), cert. denied, 472 U.S. 1007 (1985), and *Noto v. United States*, 770 F.2d 1073 (CA3 1985), affg, without opinion, 598 F. Supp. 4404 (NJ 1984).

Despite the interim reversals by the Second and Sixth Circuits in *Gajewski* and *Cull*, supra, the Tax Court has adhered to its position that a full-time gambler is engaged in a trade or business. See, e.g., *Meredith v. Commissioner*, 49 TCM 318, paragraph 84,651 P-H Memo TC (1984); *Barrish v. Commissioner*, 49 TCM 115, paragraph 84,602 P-H Memo TC (1984). It has drawn no distinction between the gambler and the active market trader. See also *Baxter v. United States*, 688 F. Supp. 912 (Nev. 1986).

6/ Some sections of the Code, however, do define the term for limited purposes. See section 355(b)(2), 26 U.S.C. section 355(b)(2) (distribution of stock of controlled corporation); sections 502(b) and 513(b), 26 U.S.C. sections 502(b) and 513(b) (exempt organizations), and section 7701(a)(26), 26 U.S.C. section 7701(a)(26) (defining the term to include "the performance of the functions of a public office").

7/ Judge Friendly some time ago observed that "the courts have properly assumed that the term includes all means of gaining a livelihood by work, even those which would scarcely be so characterized in common speech." *Trent v. Commissioner*, 291 F.2d 669, 671 (CA2 1961).

8/ We caution that in this opinion our interpretation of the phrase "trade or business" is confined to the specific sections of the Code at issue here. We do not purport to construe the phrase where it appears in other places.

9/ See, however, section 212 of the 1954 Code, 26 U.S.C. section 212. This section has its roots in section 23(a)(2) of the 1939 Code, as added by section 121 of the Revenue Act of 1942, 56 Stat. 819. It allows as a deduction all the ordinary and necessary expenses paid or incurred "for the management, conservation, or maintenance of property held for the production of income," and thus overcame the specific ruling in Higgins that expenses of that kind were not deductible. The statutory change, of course, does not read directly on the term "trade or business." Obviously, though, Congress sought to overcome Higgins and achieved that end.

10/ Deputy v. duPont, 308 U.S. 488 (1940), however, was cited by the parties in their Higgins briefs submitted to this Court. See Brief for Petitioner 28, 29, 40 and 61, and Brief for Respondent 17 and 18, in Higgins v. Commissioner, O.T. 1940, No. 253.

11/ Today, however, the vast majority of States permit some form of public gambling. The lottery, bingo, parimutuel betting, jai alai, casinos, and slot machines easily come to mind.

12/ "It takes a buyer to make a seller and it takes an opposing gambler to make a bet." Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 763 (1986).

13/ Levin v. United States, 597 F.2d 760, 765 (Ct. Cl. 1979); Commissioner v. Nubar, 185 F.2d 584, 588 (CA4 1950), cert. denied, 341 U.S. 925 (1961); Fuld v. Commissioner, 189 F.2d 465, 468-469 (CA2 1943). See also Moller v. United States, 721 F.2d 810 (CA Fed. 1983), cert. denied, 467 U.S. 1251 (1984); Purvis v. Commissioner, 580 F.2d 1882, 1884 (CA9 1976).

14/ Each of the three cases in conflict with the Seventh Circuit's decision in the present case, see n. 5, supra, was a gambler's case and adopted the Frankfurter gloss. Because the same courts, in cases not involving gamblers, have not referred to the Frankfurter gloss, see Besseney v. Commissioner, 379 F.2d 252 (CA2), cert. denied, 389 U.S. 981 (1967); Gestrich v. Commissioner, 681 F.2d 805 (CA3 1982), aff'g, without opinion, 74 T.C. 525 (1980), Main Line Distributors, Inc. v. Commissioner, 321 F.2d 562 (CA6 1963), it would appear that these courts in effect were creating a special class of, and with special rules for, the full-time gambler. We find no warrant for this in the Code.

15/ "The more he lost, the more minimum tax he has to pay." Boyle, 39 Tax Lawyer, at 754. The Commissioner concedes that application of the goods-or-services-test here "visits somewhat harsh consequences" on taxpayer Groetzinger, Brief for Petitioner 36, and "points to . . . perhaps unfortunate draftsmanship." Ibid. See also Reply Brief for Petitioner 11.

16/ It is possible, of course, that our conclusion here may subject the gambler to self-employment tax, see sections 1401-1403 of the Code, and therefore may not be an unmixed blessing for him. Federal taxes, however,

rest where Congress has placed them.

<<ENDNOTES -- JUDGE WHITE'S DISSENTING OPINION>>

1/ All references are to the Code as it stood prior to the 1986 amendments.

2/ Consider two single individuals filing for the tax year ending December 31, 1986: A has \$75,000 in nongambling income, and \$75,000 in itemized nongambling deductions; B, a full-time gambler, has \$75,000 in gambling winnings, \$75,000 in gambling losses, \$75,000 in nongambling income, and \$75,000 in itemized nongambling deductions. A's gross income and adjusted gross income are both \$75,000, and so is his alternative minimum tax base. The alternative minimum tax assessed on A is 20% of the excess of \$75,000 over \$30,000, see 26 U.S.C. sections 55(a), 55(f)(1)(B), or \$9,000.00. Assuming that full-time gambling is a trade or business, B has gross income of \$150,000, adjusted gross income of \$75,000 (because his gambling losses are attributable to a trade or business), and an alternative minimum tax base of zero (because gambling losses are deducted from adjusted gross income in computing the alternative minimum tax base). Thus, if full-time gambling were treated as a trade or business, B's gambling losses would shield him against the \$9,000 minimum tax that Congress clearly intended him to pay. "The Code should not be interpreted to allow [a taxpayer] 'the practical equivalent of a double deduction.' *Charles Ifeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934), absent a clear declaration of intent by Congress." *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969). There is no such clear declaration of intent accompanying the 1982 amendments.

3/ The Commissioner had acquiesced in *Gentile*. See 1980-2 Cum. Bull. 1, 4, n. 39.

4/ While the consequences of accepting the Commissioner's position in this case may be harsh to the respondent -- which is no doubt why Congress amended the relevant Code provisions in 1982 -- I find the Court's characterization of the result as a tax on gambling losses, ante, at \_\_\_\_\_, somewhat misleading. If gambling is not a trade or business, the practical effect of the minimum tax on tax preference items is to reduce the deduction allowed for gambling losses from an amount equal to 100% of gambling winnings to some lesser percentage of gambling winnings.

<<END

DOCUMENT>>

**Batok v. Commissioner, T.C. Memo 1992-727**

<<FULL TEXT>>

JOHN A. AND MARY L. **BATOK** v. COMMISSIONER.

Docket No. 18571-91.

Filed December 28, 1992.

John A. **Batok**, pro se.

Dale Raymond, for the respondent.

MEMORANDUM OPINION

NAMEROFF, Special Trial Judge: This case was heard pursuant to the provisions of section 7443A(b)(3) and Rules 180-182. <<ENDNOTE 1>> Respondent determined a deficiency in petitioners' Federal income tax for 1988 in the amount of \$1,693, plus an addition to tax of \$58 under section 6653(a)(1).

After concessions by petitioners, <<ENDNOTE 2>> the issues for decision are: (1) Whether petitioners are liable for self-employment tax; (2) whether petitioners are entitled to deductions for unclaimed business expenses; and (3) whether petitioners are liable for the additions to tax as determined by respondent.

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference. At the time of the filing of the petition herein, petitioners resided in Garden Grove, California. Petitioners bear the burden of showing that respondent's determinations are erroneous. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).

During 1988, petitioner wife was employed as a salesperson at Mervyn's Department Stores. Petitioner husband (hereafter referred to as petitioner) was retired. Prior to his retirement, petitioner had been an automobile mechanic. In addition, during the year at issue and for some time prior thereto, petitioner had been interested in stained and engraved glass. However, by petitioner's admission, such activity was a hobby and any sales of the stained or engraved glass were de minimis.

Sometime during 1988, petitioner was informed by a friend that M. David Paul & Associates (M. David Paul) needed someone to help install office windows. Prior to accepting this job, petitioner had never engaged in this type of work. The job lasted for approximately 1 month, for which petitioner received compensation in the amount of \$4,124.19. In early 1989, M. David Paul issued petitioner a Form 1099-MISC, reporting the

\$4,124.19 as non-employee compensation.

Petitioners filed a joint Federal income tax return for 1988 with the Internal Revenue Service on March 23, 1989. On their return for 1988, petitioners failed to report \$53 of interest income, \$2,114.17 from an IRA distribution, and \$4,124.19 of compensation from M. David Paul.

Although petitioner did not consider himself to be engaged in the trade or business of glass installation, staining, or engraving, he decided that if the IRS was going to treat him as having received self-employment income, then he is entitled to deduct the expenses which he believed to be attributable to such trade or business. Thus, on or about April 15, 1991, petitioners submitted a Form 1040X, Amended U.S. Individual Income Tax Return, containing a Schedule C which reflected income of \$4,176 and a loss of \$3,022. The Schedule C contained the following claimed deductions:

Advertising	\$320
Car/truck expenses	3,000
Depreciation	1,693
Dues/publications	85
Insurance	434
Mortgage interest	189
Laundry/cleaning	120
Legal/professional services	300
Repairs	75
Supplies	180
Taxes (license)	48
Utilities/telephone	450
Meals/entertainment	304
	-----
	\$7,198

The \$4,176 consisted of gross receipts of \$4,124 less "returns and allowances" of \$124 plus other income" of \$176. Petitioner stated the \$124 was his cost of some tools, but he cannot recall the origin of the \$176. In any event, it is not relevant herein, as respondent has not determined that amount to be income.

Respondent did not accept petitioners' amended return, and on July 31, 1992, issued a notice of deficiency determining that petitioner had failed to report interest, an IRA distribution, and nonemployee compensation. Respondent determined therein that petitioners were liable for self-employment tax on the nonemployee compensation received.

#### SELF-EMPLOYMENT TAX

We first decide whether the payment received from M. David Paul constitutes self-employment income within the meaning of section 1401 and is subject to self-employment tax. <<ENDNOTE 3>> Section 1402(a) defines

"net earnings from self-employment" subject to tax to mean "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions \* \* \* which are attributable to such trade or business". Section 1402(c) provides that the term "trade or business", as used for purposes of the self-employment provisions, generally has the same meaning as when used with respect to section 162.

Generally, to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity, regularity, and the taxpayer's purpose must be for income or profit. A sporadic activity, hobby, or amusement does not qualify. *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987). The Supreme Court has further stated that whether a taxpayer is engaged in a trade or business is a question of fact. *Higgins v. Commissioner*, 312 U.S. 212, 217 (1941).

We believe that petitioner's installation of windows for M. David Paul does not rise to the level of a trade or business. Petitioner's activity, although engaged in for profit, was neither continuous nor regular. Petitioner had never installed windows prior thereto nor at any time thereafter. Rather, petitioner's activity was a "one-time job". *Sloan v. Commissioner*, T.C. Memo. 1988-294. Accordingly, petitioners are not liable for self-employment tax on the compensation received from M. David Paul.

## SUBSTANTIATION

Although petitioner's activity of installing windows fails to rise to the level of a trade or business, deductions are still allowed for the ordinary and necessary expenses incurred for the production of income. Sec. 212(1); *Bacot v. Commissioner*, T.C. Memo. 1989-77. However, deductions claimed pursuant to section 212 are only allowable to taxpayers who itemize. Sec. 211. <<ENDNOTE 4>> Petitioners did not itemize deductions on their 1988 tax return. Moreover, for 1988, petitioners are allowed a standard deduction of \$5,000 in lieu of itemized deductions. Sec. 63(c)(2). Thus, petitioners' itemized deductions, including any section 212 deductions, would need to exceed \$5,000 to have any tax impact.

Deductions are strictly a matter of legislative grace, and petitioners bear the burden of proving they are entitled to the deductions claimed. Rule 142(a); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). If a claimed deduction is not adequately substantiated, we may be permitted to estimate expenses when we are convinced from the record that the taxpayer has incurred such expenses, and we have a basis upon which to make an estimate. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930); *Vanicek v. Commissioner*, 85 T.C. 731, 743 (1985).

Petitioner has failed to substantiate many of the expenses claimed, as he has kept no records and has presented no substantiating evidence, such as receipts or cancelled checks. The expenses claimed for car/truck expenses, depreciation, and insurance (totaling \$5,127) pertain to

nondeductible commuting expense. Petitioner also testified that some of the expenses claimed did not pertain to the activity for which he was claiming them. The only expense which petitioner has adequately substantiated is \$124 for tools. Therefore, petitioners have not substantiated any deductible expenses in excess of their allowed standard deduction.

Accordingly, we sustain respondent on this issue.

#### ADDITIONS TO TAX

Respondent also determined an addition to tax for negligence under section 6653(a)(1). Negligence under section 6653(a)(1) is the lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances. *Neely v. Commissioner*, 85 T.C. 934, 947 (1985). Petitioners also have the burden of proof on this issue. *Bixby v. Commissioner*, 58 T.C. 757, 791 (1972). Based on this record, we believe that petitioners acted negligently. Petitioners' failure to report the interest, IRA distribution, and nonemployee compensation which they received constituted negligence. Accordingly, we sustain respondent on this issue.

To reflect the foregoing,

Decision will be entered  
under Rule 155.

<<ENDNOTES>>

1/ All section references are to the Internal Revenue Code in effect for the year at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

2/ Petitioners have conceded that they failed to report \$53 of interest income, an IRA distribution of \$2,114.17, and \$4,124.19 of nonemployee compensation. In addition, petitioners have conceded various losses which they claimed they incurred in 1988.

3/ Neither party raised this issue, but it became obvious to the Court during trial that the issue (which represents a substantial portion of the deficiency determined) should be considered, and the parties were advised of same.

4/ Only sec. 212 expenses attributable to property held for the production of rents or royalties are deductible from gross income in determining adjusted gross income. Sec. 62(a)(4).

## **REV. RUL. 72-86**

Advice has been requested whether fees received by a director of a corporation under the circumstances described below are includible in computing his net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954).

The director is elected to his position on the board of directors by the stockholders of the corporation. In accordance with its bylaws, its board has four meetings annually in order to manage the corporate affairs. The director is required to attend each meeting and he receives an annual fee for the performance of his duties as a director.

Section 1402(a) of the Act provides, in part, that the term "net earnings from self-employment" means the gross income derived by an individual from any trade or business that he carries on, less the allowable deductions that are attributable to such trade or business.

Section 1402(c) provides that the term "trade or business", when used with reference to "net earnings from self-employment", shall, with certain exceptions not here material, have the same meaning as when used in section 162 of the Code, relating to trade or business expenses.

Whether or not a person is engaged in a trade or business is dependent upon all the facts and circumstances in a particular case.

Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. A "trade or business" is generally defined as that branch of activities wherein an individual expends his usual everyday efforts to gain a livelihood. See Revenue Ruling 69-645, C.B. 1969-2, 37.

The case of *Doggett v. Burnet*, 65 F. 2d 191 (1933), concerned the question of whether the taxpayer was, in fact, engaged in a "trade or business". The court stated that the proper test was whether the activity was entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit could be realized thereon, rather than being conducted merely for pleasure, exhibition, or social diversion.

Revenue Ruling 69-645, after discussing the *Doggett* case, points out that since the taxpayer referred to in the Revenue Ruling undertook his duties as a minister with no expectation of receiving compensation, he did not undertake the position for a profit or in the belief that a profit could be realized from it. However, when a taxpayer does expect to be paid for his work, it is assumed that he is in the business of earning his pay. See *Noland v. Commissioner*, 269 F. 2d 108 (1959), certiorari denied 361 U.S. 885 (1959).

In the instant case, the director works on a regular, habitual, and periodic basis in the expectation of receiving annual compensation for his work; he is elected to his position by the stockholders of the corporation on the basis of his special qualities which they feel will be of value to the corporation; he attempts to fulfill their expectations by devoting his energies to maintaining and improving the business of the corporation; he is entrusted with regular and continuing management responsibilities; and he protects not only his personal interests but those of the corporation and all its stockholders. Therefore, the director is engaged in a "trade or business" for purposes of section 162 of the Code.

Accordingly, it is held that the fees received by the director in the instant case are includible in computing his net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954.

Revenue Ruling 58-5, C.B. 1958-1, 322, which holds, in part, that a nonprofessional fiduciary, that is, ordinarily someone who serves only in isolated instances and generally is selected only because of a personal relationship rather than because of any special knowledge or expertise he may have, will not be treated as receiving income from a trade or business unless a number of special conditions are met, is distinguished since the instant case involves an individual who is engaged in a business rather than in the capacity of a nonprofessional fiduciary.

See also Revenue Ruling 68-595, C.B. 1968-2, 378, which holds that fees and other remuneration received by a director of a corporation for services performed on committees of its board of directors are self-employment income within the meaning of section 1402(b) of the Act.

**REV. RUL. 77-356**

Advice has been requested whether, under the circumstances described below, amounts received by an individual for giving speeches are includible in net earnings from self-employment for purposes of the Self-Employment Contributions Act (chapter 2, subtitle A, Internal Revenue Code of 1954).

A member of the United States Congress frequently receives invitations to speak on matters upon which the Member is an expert. The acceptance of an invitation depends on the Member's availability and the amount of time the Member would have to spend away from Congressional duties. There is no pattern to the number of speeches given and the remuneration received. Many invitations are accepted in order to set forth the Member's views on national policy in the Member's area of expertise. During the taxable year in question the Member made 10 speeches for which \$1,500 was received.

Section 1402(a) of the SECA provides that the term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by the individual, less the deductions allowed by subtitle A of the Code (relating to income taxes) that are attributable to the trade or business.

Section 1402(c) of the SECA provides that the term "trade or business" has the same meaning as it does in section 162 of the Code (relating to trade or business expenses), with certain specified exceptions. One of the exceptions is contained in section 1402(c)(1) which provides that the term does not include the performance of the functions of a public office (other than certain State or local public officers who are paid on a fee basis).

Section 1.1402(c)-2(b) of the Income Tax Regulations provides that for purposes of the exception in section 1402(c)(1) of the SECA, relating to public officers, a member of Congress performs the functions of a public office.

In *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), the Supreme Court stated that a business is that which occupies the time, attention, and labor of men for the purpose of livelihood or profit. In *Deputy v. duPont*, 308 U.S. 488 (1940), Ct.D. 1435, 1940-1 C.B. 118, it is stated that carrying on a trade or business involves holding one's self out to others as engaged in the selling of goods or services. An isolated or occasional activity is not a business. However, an individual may engage in several trades or occupations either independent of, or in connection with, his principal business. *Freedman v. Commissioner*, 301 F.2d 359 (5th Cir. 1962); *Joseph M. Philbin*, 26 T.C. 1159 (1956).

Rev. Rul. 55-431, 1955-2 C.B. 312, concludes that an individual who accepts an occasional invitation to make a speech for which an honorarium is received is not engaged in a trade or business for self-employment tax purposes. That Revenue Ruling further states, however, that whether a

certain activity constitutes engaging in a "trade or business" is dependent upon all the facts and circumstances in the particular case. In this regard and as a general rule, Rev. Rul. 55-431 also provides that when a person is regularly engaged in an occupation or profession for profit and, as to such occupation or profession, is not regarded as an employee for purposes of the taxes imposed by the Federal Insurance Contributions Act or otherwise excluded from the self-employment provisions, the person is engaged in a trade or business. Thus, lecturing or speech making may or may not be a trade or business, depending upon whether such engagements are carried on with a degree of regularity, whether the individual seeks or otherwise indicates availability for speaking engagements, and whether the individual receives compensation for such speech making.

During the taxable year the Member of Congress received \$1,500 from 10 speaking engagements. The frequency of the speaking engagements indicates a degree of recurrence, continuity, and availability for speech making, and the amount received during the year was compensatory. Although the Member of Congress is a public official in the performance of congressional duties, the income from the speaking engagements is not derived from performing those duties. The income from giving speeches is derived from the separate trade or business of speech making.

Accordingly, the amount received in the subject case during the taxable year for giving speeches is includible in computing the Member's net earnings from self-employment for purposes of the Self-Employment Contributions Act.

Rev. Rul. 55-431 is amplified.

**REV. RUL. 58-5**

The Internal Revenue Service has been requested to outline guides for determining when income received by fiduciaries of decedents' estates should be considered in computing net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954 (chapter 2, subtitle A, Internal Revenue Code of 1954.)

Section 1402 of the Act provides, in part, as follows:

(a) NET EARNINGS FROM SELF-EMPLOYMENT.--The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle [subtitle A] which are attributable to such trade or business, \* \* \*.

In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not a person is engaged in a trade or business is dependent upon all of the facts and circumstances in the particular case. However, the following will serve as guides in determining this question in the case of fiduciaries of decedents' estates:

(1) Professional fiduciaries will always be treated as being engaged in the trade or business of being fiduciaries, regardless of the assets contained in the estate.

(2) Generally, nonprofessional fiduciaries (that is, for example, persons who serve as executor or administrator in isolated instances, and then as personal representative for the estate of a deceased friend or relative) will not be treated as receiving income from a trade or business unless all of the following conditions are met:

(a) There is a trade or business among the assets of the estate,

(b) The executor actively participates in the operation of this trade or business,

(c) The fees of the executor are related to the operation of the trade or business.

The following examples represent applications of the above guides with respect to nonprofessional executors or administrators of decedents' estates:

EXAMPLE (1). Executor who receives a flat fee for administering the estate. A, a nonprofessional fiduciary, receives a flat \$10,000 for administering the estate of B. B's gross estate is valued at \$150,000 and

includes a trade or business which A manages for the period of time required to distribute the assets of the estate. Under the laws of the State in which b's estate is probated, an executor is entitled to a five percent commission based upon the value of the assets distributed. Since A distributed the entire estate worth \$150,000 he would have been entitled to \$7,500 executor's commissions, based upon the statutory five percent allowance. Inasmuch as A, pursuant to court order, actually received \$10,000 instead of \$7,500 in commissions, the excess, or \$2,500, is regarded as being attributable to the operation of the trade or business of the estate. A must therefore treat this \$2,500 as earnings from self-employment. The remaining \$7,500 is regarded as being attributable to the normal fiduciary duties of marshalling the assets of the estate and should not be treated as trade or business income. On the other hand, if A's total fee for administering the estate was equal to or less than \$7,500 (the statutory executor's allowance in this case), and if nothing was said in the court order with respect to allocation of the fee, the entire fee would be regarded as being attributable to A's fiduciary activities and no part of the fee would be treated as trade or business income to A.

EXAMPLE (2). Executrix who receives a special fee for handling the estate's business. C, the sole executrix of the estate of her husband, operates a drugstore belonging to the estate, pending dissolution of the estate. As her commission for handling the estate, C receives, pursuant to court order, \$5,125 (based upon a percentage of the value of the assets distributed) and \$500, in addition, for the operation of the drugstore. Under these circumstances, only the \$500 commission for the operation of the drugstore constitutes earnings from self-employment. The \$5,125 commission, based upon the value of the assets distributed is not related to the operation of the trade or business, and, accordingly, does not constitute earnings from self-employment.

EXAMPLE (3). Coexecutor who does not participate in the operation of the estate's business. D and E are coexecutors of an estate which includes a trade or business. D is totally unfamiliar with the operation of the business and leaves the entire management of the business to E. Under these circumstances, D who does not participate in the operation of the business, cannot be treated as being in a trade or business. The fees received by D do not constitute net earnings from self-employment. E, however, actively participates in the operation of the business and the compensation received by him for the management of the estate's trade or business constitutes net earnings from self-employment.

In some cases the activities of the executor of a single estate may constitute the conduct of a trade or business even though the assets of the estate do not include a trade or business as such. If, for example, an executor manages an estate which requires extensive management activities on his part over a long period of time, an examination of the facts may show that such activities are sufficient in scope and duration to constitute the carrying on of a trade or business. If doubt exists

concerning the status of a fiduciary believed to be in this category, the complete facts should be transmitted to the National Office for consideration. See Rev. Rul. 54-172, C.B. 1954-1, 394.

<<END RULING>>

Final Regs  
Federal Regulations

**2. Reg § 1.1402(a)-2. Computation of net earnings from self-employment.**

**Caution:** The Treasury has not yet amended Reg § 1.1402(a)-2 to reflect changes made by P.L. 98-21

**(a) General rule.** In general, the gross income and deductions of an individual attributable to a trade or business (including a trade or business conducted by an employee referred to in paragraphs (b), (c), (d), or (e) of §1.1402(c)-3), for the purpose of ascertaining his net earnings from self-employment, are to be determined by reference to the provisions of law and regulations applicable with respect to the taxes imposed by sections 1 and 3. Thus, if an individual uses the accrual method of accounting in computing taxable income from a trade or business for the purpose of the tax imposed by section 1 or 3, he must use the same method in determining net earnings from self-employment. Likewise, if a taxpayer engaged in a trade or business of selling property on the installment plan elects, under the provisions of section 453, to use the installment method in computing income for purposes of the tax under section 1 or 3, he must use the same method in determining net earnings from self-employment. Income which is excludable from gross income under any provision of subtitle A of the Internal Revenue Code is not taken into account in determining net earnings from self-employment except as otherwise provided in §1.1402(a)-9, relating to certain residents of Puerto Rico, in §1.1402(a)-11, relating to ministers or members of religious orders, and in §1.1402(a)-12, relating to the term “possession of the United States” as used for purposes of the tax on self-employment income. Thus, in the case of a citizen of the United States conducting, in a foreign country, a trade or business in which both personal services and capital are material income-producing factors, any part of the income as earned income therefrom which is excluded from gross income as earned income under the provisions of section 911 and the regulations thereunder is not taken into account in determining net earnings from self-employment.

**(b) Trade or business carried on.** The trade or business must be carried on by the individual, either personally or through agents or employees. Accordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.

**(c) Aggregate net earnings.** Where an individual is engaged in more than one trade or business within the meaning of section 1402(c) and §1.1402(c)-1, his net earnings from self-employment consist of the aggregate of the net income and losses (computed subject to the special rules provided in §§ 1.1402(a)-1 to 1.1402(a)-17, inclusive) of all such trades or businesses carried on by him. Thus, a loss sustained in one trade or business carried on by an individual will operate to offset the income derived by him from another trade or business.

**(d) Partnerships.** The net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the income or loss, described in section 702(a)(9), from any trade or business carried on by each partnership of which he is a member. An individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704, subject to the special rules set forth in section 1402(a) and in §§1.1402(a)-1 to 1.1402(a)-17, inclusive, and to the exclusions provided in section 1402(c) and §§1.1402(c)-2 to 1.1402(c)-7, inclusive. For provisions relating to the computation of the taxable income of a partnership, see section 703.

**(e) Different taxable years.** If the taxable year of a partner differs from that of the partnership, the partner shall include, in computing net earnings from self-employment, his distributive share of the income or loss, described in section 702(a)(9), of the partnership for its taxable year ending with or within the taxable year of the partner. For the special rule in case of the termination of a partner's taxable year as result of death, see §§1.1402(f) and 1.1402(f)-1.

**(f) Meaning of partnerships.** For the purpose of determining net earnings from self-employment, a partnership is one which is recognized as such for income tax purposes. For income tax purposes, the term "partnership" includes not only a partnership as known at common law, but, also a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any trade or business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or a corporation. An organization described in the preceding sentence shall be treated as a partnership for purposes of the tax on self-employment income even though such organization has elected, pursuant to section 1361 and the regulations thereunder, to be taxed as a domestic corporation.

**(g) Nature of partnership interest.** The net earnings from self-employment of a partner include his distributive share of the income or loss, described in section 702(a)(9), of the partnership of which he is a member, irrespective of the nature of his membership. Thus, in determining his net earnings from self-employment, a limited or inactive partner includes his distributive share of such partnership income or loss. In the case of a partner who is a member of a partnership with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702(a)(9), from the trade or business carried on by the partnership computed without regard to the fact that the partnership has elected to be taxed as a domestic corporation.

**(h) Proprietorship taxed as domestic corporation.** A proprietor of an unincorporated business enterprise with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation shall compute his net earnings from self-employment without regard to the fact that such election has been made.

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T.D. 6691, 12/2/63 , amend T.D. 7333, 12/19/74 .

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Prop Reg § 1.1402(a)-2. Computation of net earnings from self-employment.

**Caution:** The Treasury has not yet amended Reg § 1.1402(a)-2 to reflect changes made by P.L. 105-34

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**(d)** \*\*\* Except as otherwise provided in section 1402(a) and paragraph (g) of this section, an individual's net earnings from self-employment include the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by each partnership of which the individual is a partner. \*\*\*

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**(f)** \*\*\* For rules governing the classification of an organization as a partnership or otherwise, see §§301.7701-1, 301.7701-2, and 301.7701-3 of this chapter.

**(g) Distributive share of limited partner.** An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.

**(h) Definition of limited partner.**

**(1)** 1.1402(a)-2(h)(1)1 *In general.* Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.

**(2)** 1.1402(a)-2(h)(2)2 *Limited partner.* An individual is treated as a limited partner under this paragraph (h)(2) unless the individual—

**(i)** 1.1402(a)-2(h)(2)(i)i Has personal liability (as defined in §301.7701-3(b)(2)(ii) of this chapter for the debts of or claims against the partnership by reason of being a partner;

**(ii)** 1.1402(a)-2(h)(2)(ii)ii Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; or

**(iii)** 1.1402(a)-2(h)(2)(iii)iii Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

**(3)** 1.1402(a)-2(h)(3)3 *Exception for holders of more than one class of interest.* An individual holding more than one class of interest in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—

**(i)** 1.1402(a)-2(h)(3)(i)i Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

**(ii)** 1.1402(a)-2(h)(3)(ii)ii The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

**(4)** 1.1402(a)-2(h)(4)4 *Exception for holders of only one class of interest.* An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

**(i)** 1.1402(a)-2(h)(4)(i)i Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

**(ii)** 1.1402(a)-2(h)(4)(ii)ii The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

**(5)** 1.1402(a)-2(h)(5)5 *Exception for service partners in service partnerships.* An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

**(6)** 1.1402(a)-2(h)(6)6 *Additional definitions.* Solely for purposes of this paragraph (h)—

**(i)** 1.1402(a)-2(h)(6)(i)i A *class of interest* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants

the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

**(ii)** 1.1402(a)-2(h)(6)(ii)ii A *service partner* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

**(iii)** 1.1402(a)-2(h)(6)(iii)iii A *service partnership* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

**(iv)** 1.1402(a)-2(h)(6)(iv)iv A *substantial interest in a class of interest* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

**(i) Example.** The following example illustrates the principles of paragraphs (g) and (h) of this section:

*Example.* (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute \$1x for one LLC unit. B contributes \$2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of \$6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of \$10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) Application of general rule of paragraph (h)(2) of this section. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section. B's guaranteed payment of \$6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to

contract for LLC under State's law, B does participate in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) Distributive share included in net earnings from self-employment. C's guaranteed payment of \$10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

**(j) Effective date.** Paragraphs (d), (e), (f), (g), (h), and (i) are applicable beginning with the individual's first taxable year beginning on or after the date this section is published as a final regulation in the Federal Register.

**PLR 200403056 9/29/2003**

Code Section 1402

\* Section 1402: Retirement payments to retired partners

This is in reply to your request for a ruling concerning whether payments made under a retirement plan maintained by the Firm for retired partners satisfies the requirements of Internal Revenue Code section 1402(a)(10), and are, therefore, excludible from gross income when determining net earnings from self-employment.

The Firm is a professional limited liability partnership engaged in the practice of law. The Firm is classified as a partnership for federal income tax purposes. The members of the Firm are treated as partners for federal income tax purposes, and are hereafter referred to as partners. The Firm files income tax returns based upon a calendar year. All partners in the Firm are individuals and are calendar year taxpayers.

The Firm maintains an unfunded retirement benefit program (the "Retirement Program") for its partners that provides for payments directly from the Firm to retired partners. The Retirement Program is set forth in the partnership agreement governing the operations of the Firm.

Under the Retirement Program, a partner may elect to retire at any time after reaching age 60. If a partner retires prior to age 60, unless the partner has 25 years of service with the Firm at the time of retirement, benefits will commence to be paid in the year the retired partner attains age 60. If a partner has 25 years of service with the Firm at the time of retirement, the earliest time at which the payment of benefits would commence would be the year in which the partner attains age 55. To be entitled to any benefit under the Retirement Program a partner must have at least 5 years of service with the Firm.

For purposes of the Retirement Program, partners of the Firm are divided into two classes, general partners and special partners. A general partner has an interest in the net earnings of the Firm and is eligible for additional amounts awarded at the discretion of the Firm. A special partner receives a guaranteed payment and is eligible for additional compensation awarded at the discretion of the Firm. Each retiring general partner is entitled to 150 percent of the partner's highest annual calendar year compensation during the final four years of service as a partner at the Firm. Each retiring special partner is entitled to 100 percent of the partner's average annual calendar year compensation during the final five calendar years of service as a partner at the Firm. If a retiring general partner or special partner does not reach a certain minimum number of years of service with the Firm, the Retirement Program provides for a reduction in the retirement payments.

Payments under the Retirement Program are made in five annual

installments. The first installment is payable within 90 days after the first day of the "payment commencement year" for the retired partner, with the remaining four installment payments being made within 90 days after the first day of the next four calendar years. For a general partner, the payment commencement year is the later of the second calendar year following the calendar year in which the retirement date for the general partner occurs, or the calendar year in which the general partner attains age 60. However, if the general partner has 25 or more years of service with the Firm, the relevant calendar year will be the year in which the general partner attains age 55. For a special partner, the payment commencement year is the later of calendar year following the calendar year in which the retirement date for the special partner occurs, or the calendar year in which the special partner attains age 60. However, if the partner has 25 years or more of service with the Firm, the relevant calendar year will be the year in which the special partner attains age 55.

A retired partner receives all compensation due for the year the partner retires by March 15 of the following calendar year. The retired partner's capital account in the Firm is distributed to the partner prior to March 31 of the following calendar year. Thus, both compensation due and the retired partners' capital account will be distributed during the calendar year preceding the commencement of retirement payments for a general partner and by the end of March in the calendar year in which retirement payments commence for special partners.

The initial retirement payments are paid out in five annual installments. After this series of annual payments is completed, and provided the retired partner is still living, the retired partner is entitled to payments of \$100 per month for the rest of the retired partner's life.

In addition to the retirement payments under the Retirement Program for retired partners, the Firm has another program pursuant to which a retired partner may be entitled to additional amounts from the Firm after the partner has received the final distribution of partnership income for the year of retirement and the partner's capital account has been distributed. Investments are made under the Firm's investment program from after-tax funds of the partners. A partner retiring or leaving the Firm may continue to have an interest in investments made under the program. However, a retired partner is not entitled to any voting rights or other rights with respect to the Firm. The only right a retired partner has is to receive distributions from the investment program, if and when made to all partners and terminated partners with similar entitlements. The Firm will amend the partnership agreement to provide a retiring partner with two options under the investment program. A retiring partner may elect either (1) to have the partner's investment in the Firm's investment program valued and paid to the partner before the close of the Firm's taxable year, or (2) the partner may elect to continue to have an interest in the Firm's investment program. The Firm states that if a retired partner elects the second option, all payments made by the Firm to the retired partner during the year will not be treated by the Firm or the retired

partner as excluded from "net earnings from self-employment" under section 1402(a)(10).

In general, a partner will not render any services to the Firm following the partner's retirement from the Firm. However, in rare cases a retired partner will enter into an "of counsel" relationship with the Firm pursuant to which the retired partner performs occasional services for the Firm in exchange for agreed compensation. The Firm states that all payments made to a retired partner during a year with respect to which compensation is being received under the "of counsel" arrangement would not be treated by the Firm or the retired partner as excluded from "net earnings from self-employment" under section 1402(a)(10).

Section 1401 imposes a tax on the self-employment income of every individual. Section 1402(b) defines "self-employment income" as the "net earnings from self-employment" derived by the individual, subject to certain conditions and limitations.

Section 1402(a), in defining the term "net earnings from self-employment," specifically excludes retirement payments to a partner if the requirements in section 1402(a)(10) and the regulations thereunder are met.

Section 1402(a)(10) and section 1.1402(a)-17 of the Income Tax Regulations provide that such retirement payments are excluded from "net earnings from self-employment" if:

(1) the payments are made on a periodic basis by a partnership pursuant to a written plan that provides for payments on account of retirement to partners generally or to a class or classes of partners to continue at least until the partner's death (to qualify as payments on account of retirement, the payments must constitute bona fide retirement income; generally, retirement benefits are measured by, and based on, such factors as years of service and compensation received);

(2) the retired partner to whom the payments are made rendered no service with respect to any trade or business carried on by the partnership (or its successors) during the taxable year of the partnership (or its successors), which ends within or with the taxable year of the partner and in which the payment was received;

(3) no obligation exists (as of the close of the partnership year referred to in (2) above) from the other partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and

(4) the retired partner's share of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in (2) above.

Regulation section 1.1402(a)-17 provides that by operations of the conditions set forth in the above subparagraphs either all payments on account of retirement received by a retired partner during the taxable year of the partnership ending within or with the taxable year of the partnership are excluded or none of the payments are excluded. The regulations further provides that the effects of the conditions set forth in (3) and (4) above is that the exclusion may apply with respect to such payments received by the retired partner during the taxable year only if at the close of the partnership taxable year the retired partner has no financial interest in the partnership except for the right to retirement payments.

On the basis of the facts presented, the Firm's Retirement Program would be considered a bona fide retirement plan, within the meaning of section 1402(a)(10). The Retirement Program provides for payment to each retiring partner on the basis of the partner's age, physical condition and years of service; or a combination of age and physical condition and years of service. Although the payments by the Firm are likely to be reduced after the initial annual payments, once the annual payments conclude, monthly payments that never fall below \$100 per month will continue until the retired partner's death.

Additionally, except for payments made to a partner providing services as "of counsel" and a partner electing to continue participation in the investment arrangements, the facts establish that payments made to retired partners from the Retirement Program meets the conditions for exclusion under regulation section 1.1402(a)-17(c)(i) and (ii). The retired partner will withdraw his entire capital account by the end of the taxable year of the Firm in which the payments commence and the Firm will also distribute the entire value of the retired partner's interest in the Firm's investment program by the end of the taxable year in which retirement payments commence. Thus, neither the Firm nor the other partners will have any obligations to the retired partner other than the retirement payments under the Retirement Program.

Therefore, retirement payments made by the Firm under the Retirement Program to a retired partner will be excluded from "net earnings from self-employment" by section 1402(a)(10) if (1) the retired partner renders no service during the taxable year of the Firm which ends within or with the taxable year of the partner and in which the payment is received, (2) at the close of that taxable year of the Firm, no obligation exists from the partners to the retired partner except with respect to retirement payments under the plan or rights such as benefits payable on account of sickness, accident, hospitalization, medical expenses, or death; and (3) at the close of that taxable year of the Firm, the retired partner's share of the capital of the Firm has been paid to him in full.

However, in any year when a retired partner renders service to the Firm as "of counsel" and/or continues to participate in the Firm's investment program, the retired partner will not satisfy section 1.1402(a)-17(c), and all payments received by such retired partner during the taxable year of

the Firm ending within or with the retired partner's taxable year are not excludible from net earnings from self-employment under section 1402(a)(10).

No opinion is expressed as to the income tax consequences to the participants, the Firm or the other partners, of participation in the Retirement Program. Specifically, no opinion is expressed as to the amount or timing of any recognition of income or deductions due to participation in or sponsorship of the Retirement Program, the application of sections 83, 402 or 451, or the doctrines of constructive receipt or economic benefit. Accordingly, no opinion is expressed as to the amount or timing of any recognition of self-employment income under section 1402 . Rather, this ruling addresses only whether, to the extent any self-employment income would otherwise be recognized by a participant in the Retirement Program, section 1402 would operate to exclude such income from self-employment income.

Furthermore, no opinion is expressed as to the treatment of the payments to the retired partners under Subtitle A, Chapter 1, Subchapter K of the Code and under other provisions of Subtitle A, Chapter 2 of the Code, except for section 1402(a)(10) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Will E. McLeod  
Chief, Employment Tax Branch 1  
Division Counsel/Associate  
Chief Counsel  
(Tax Exempt and Government Entities)

## **Countries with Totalization Agreements with US**

Australia  
Austria  
Belgium  
Canada  
Chile  
Finland  
France  
Germany  
Greece  
Ireland  
Italy  
Luxembourg  
Netherlands  
Norway  
Portugal  
South Korea  
Spain  
Sweden  
Switzerland  
United Kingdom

**REV. RUL. 70-402** <<ENDNOTE 1>>

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in S.S.T. 33, C.B. XV-2,403 (1936).

Three questions are presented concerning liability for the tax under the Federal Unemployment Tax Act (chapter 23, subtitle C, Internal Revenue Code of 1954) under the situations set forth below.

**SITUATION 1.**

A and B are partners in two stores in different towns. Each store employs two persons. Would the employment of the four persons in the two stores make the partnership an employer under the terms of the Act?

Section 3306(a) of the Act provides that for purposes of chapter 23 the term "employer" does not include any person unless on each of some 20 days during the taxable year or during the preceding taxable year, each day being in a different calendar week, the total number of individuals who were employed by him in employment for some portion of the day (whether or not at the same moment of time) was four or more.

For purposes of section 3306(a) of the Act it is held that all the employees of the partnership must be included in determining whether it is an employer of four or more individuals. Accordingly, the employment of four or more individuals in both stores make the partnership an "employer" under the Act, provided the "20 day" test is met during the taxable year or the preceding taxable year.

**SITUATION 2.**

C and D, who are not related, are partners in the same store. In addition to other employees, their wives and minor children perform services in the store on occasions. If the members of the family are counted as employees, the owners have more than four employees. The question presented is whether, if such members of the family draw no wages, C and D are liable for the tax as having four or more employees, including the members of the family.

The term "employment," as defined in the Act, includes any service performed in the United States by an employee for the person employing him, with certain exceptions. One of the exceptions from "employment" is service performed by an individual in the employ of his son, daughter, or spouse, and service performed by a child under the age of 21 in the employ of his father or mother.

Section 31.3306(c)(5)-1 of the Employment Tax Regulations provides, in part, that the family employment exception is conditioned solely upon the

family relationship between the employee and the individual employing him. Services performed in the employ of a partnership are not within the exception unless the requisite family relationship exists between the employee and each of the partners comprising the partnership. Services performed in the employ of a corporation are not within the exception.

Although the measure of the tax imposed by the Act is the total "wages" paid by the employer with respect to employment, there is no provision in the Act or the regulations under which it is necessary that wages or other remuneration be paid to an individual rendering services for another in order for the individual to be an "employee" within the meaning of the Act. As the amount of wages or other remuneration, if any, that is to be paid to an individual for services rendered is a matter solely between the individual and the person for whom the services are performed, the fact that such individual receives no salary or remuneration is not material in determining whether he is to be regarded as an employee for the purpose of the taxing provisions of the Act. Accordingly, the members of the families of the partners who perform services in the employ of the partnership are to be counted as employees in determining whether the partnership is the employer of four or more individuals, whether or not such members of the partners' families receive remuneration for the services rendered in such employment.

### SITUATION 3.

The same facts exist as in Situation 2 except that the store is incorporated. The question presented is whether the same conclusion applies as in Situation 2.

The conclusion set forth in Situation 2 is equally applicable with respect to the members of the families of the officers or stockholders of the corporation in Situation 3.

S.S.T. 33 is superseded, since the position set forth therein is restated under current law in this Revenue Ruling.

<<ENDNOTES>>

1/ Prepared pursuant to Rev. Proc. 67-6, 1967-1 C.B. 576.

<<END RULING>>