Estate & Succession Planning Corner

By Lawrence I. Richman

Spousal Qualified Joint Ventures

In our July–August, 2003 column regarding the challenges of using passthrough entities for property owned by married couples, we noted how the disregarded entity rules treated married couples in community and separate property jurisdictions in dramatically different ways. Married couples residing in community property states had the benefits of Rev. Proc. 2002-69,[1] which allows flow-through entities solely owned by them to be disregarded for federal tax purposes as long as the business entity is a "qualified entity." In order to be a qualified entity, the entity must be (1) a flow-through business entity that is not a corporation, (2) be wholly owned by a husband and wife as community property and (3) not be considered owned by anyone other than one or both spouses for federal tax purposes. Our 2003 column pointed out that there was no similar guidance or opportunity for married couples who do not reside in a community property jurisdiction.

The recently enacted Small Business and Work Opportunity Tax Act of 2007 (the "2007 Act")[2] made an important change in bringing some measure of parity (albeit an incomplete measure of parity) in the treatment of married couples in community and separate (noncommunity) property jurisdictions.

The Small Business Tax Relief provisions of the 2007 Act amended Code Sec. 761 to statutorily authorize disregarded entity treatment for a "Qualified Joint Venture."[3] A qualified joint venture is a joint venture involving the conduct of a trade or business (1) if its only members are a husband and wife, (2) if each of the spouses materially participates in the trade or business and (3) if both spouses elect to treat the business entity as a qualified joint venture (*i.e.,* both

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spouses elect to treat the entity as disregarded for federal tax purposes). The material participation test is the one under Code Sec. 469(h), except that the material participation of one spouse does not count as material participation for the other spouse.

Once it is determined that the entity falls within the definition of a qualified joint venture, an election under 761(f) may be made by a husband and wife if they file a joint return for the taxable year. The 761(f) election causes (1) the joint venture to be disregarded for federal tax purposes, (2) all items of income, gain, loss, deduction and credit to be divided between the spouses in accordance with their respective interests in the venture and (3) for each spouse to treat these reportable items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor.

So, does the 2007 Act provide separate property state residents parity with their community property state fellow citizens? On balance, not really. While Rev. Proc. 2002-69 allowed husbands and wives in community property states to own any investment, from a vacation home, to a vineyard, to a portfolio of securities, in any flow-through entity, including a limited partnership, the 2007 Act's material participation requirement for each spouse is severely limiting for planning purposes. A limited partnership owned by a husband and wife, for example, would fail as a qualified joint venture unless both spouses were general partners who materially participated in the venture.

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Why then the focus on material participation? The answer seems to revolve around the Schedule C reporting of the qualified joint venture and the government's interest in treating the net earnings of a disregarded entity as net earnings from self employment. By viewing the net earnings of a disregarded business entity in which a taxpayer materially participates as net earnings from self employment, the government ignores the portion of net earnings that represent a return on capital, particularly intangible capital.

The Technical Explanation of the Joint Committee states: "For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for Federal income tax purposes under the provision (*i.e.,* in accordance with their respective interests in the venture). A corresponding change is made to the definition of net earnings from self-employment under the Social Security Act. The provision is not intended to prevent allocations or reallocations, to the extent permitted under present law, by courts or by the Social Security Administration of net earnings from self-employment for purposes of determining Social Security benefits of an individual."[4]

One may infer from this language that the government is concerned that husbands and wives could use the qualified joint venture rules to "game" the social security system. Under Code Sec. 761, if a qualified joint venture election is made, the net earnings of a limited liability company owned equally by husband and wife in which each materially participates should be reported on Schedule C as earnings from self-employment, with each spouse treating half of the net income as net earnings from self-employment for purposes of determining social security benefits. This would appear to be the case (subject to possible reallocation) even if the wife were the brains behind the business and provided its intellectual capital, and the husband functioned as her administrative assistant. It is relatively simple to imagine other scenarios designed to maximize social security benefits for each spouse.

The issue arises specifically from the way in which Schedule C reporting limits the ability of sole proprietors to define what constitutes self-employment income, particularly when the success of the business is due to a business method or other intellectual capital. For husbands and wives in separate property states, it is the material participation requirement for each which places them in a disadvantageous position compared to community property husbands and wives. What then if the material participation requirements were deleted from Code Sec. 761? Relative parity could be achieved, but you may ask, what about our social security system? Perhaps one place to begin is with the treatment of the single individual owner

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"S" corporation in which the owner materially participates. The treatment of its earnings, and the allocation of those earnings between self-employment income (reasonable compensation) and return on capital, provide a way to begin to think about the issue.

Over four years ago we discussed the planning advantages enjoyed by husbands and wives living in community property states and bemoaned the lack of planning flexibility for their separate property co-citizen husbands and wives. The enactment of the qualified joint venture election under Code Sec. 761(f) is an important step toward parity, albeit an incomplete one.

Endnotes

[1] Rev. Proc. 2002-69, IRB 2002-45, 831, 2002-2 CB 831.

[2] Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28).

[3] Act Sec. 8215 of P.L. 110-28, now Code Sec. 761(f).

[4] Joint Committee on Taxation (J.C.T. Rep. No. JCX-29-07).

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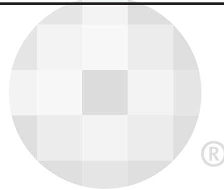

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