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Significant Service Center Advice

This responds to your request for technical assistance dated March 31, 1997, in connection with questions posed by the Self-Employment Tax Coordinator of the Cincinnati Service Center.

Disclosure Statement

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Issues

- (1) What is the correct method of taking the deduction provided by section 1402(a)(12).
- (2) Whether the taxpayer has an option in the method used to take the deduction provided by section 1402(a)(12).
- (3) Whether section 1402(a)(12) provides an "optional" method of calculating self-employment tax liability.
- (4) Whether the deduction provided by section 164(f) of the Internal Revenue Code for one half of self-employment tax liability can be taken in computing net earnings from self-employment under section 1402.

Conclusions

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(1) The deduction provided by section 1402(a)(12) is built into the calculation of self-employment tax liability on Form 1040 Schedule SE. The taking of this deduction is reflected in the step on Schedule SE in which taxpayers multiply trade and business income by .9235 to arrive at net earnings from self-employment. See line 4 of 1996 Short Schedule SE and lines 4a and 5b of 1996 Long Schedule SE.

(2) The only correct method of taking the deduction provided by section 1402(a)(12) is to complete the computation of self-employment tax liability on the Schedule SE. The section 1402(a)(12) deduction cannot be taken as a deduction on Schedule C, or as a deduction on Schedule SE additional to the deduction already built into the self-employment calculation on Schedule SE.

(3) Section 1402(a)(12) does not provide an optional method of computing self-employment tax liability. Taxpayers must follow the computational method set forth on Schedule SE in calculating self-employment tax liability.

(4) The deduction provided by section 164(f) cannot be taken in computing self-employment tax liability. Under section 1402(a)(12), the deduction provided by section 1402(a)(12) is taken in place of the section 164(f) deduction in calculating net earnings from self-employment. The deduction provided by section 164(f) can only be taken as a deduction in calculating income tax liability as provided on line 25 of 1996 Form 1040.

Facts

According to the information submitted, issues have been raised about the calculation of liability for self-employment tax. Different methods of taking the deductions provided by section 164(f) and section 1402(a)(12) have been proposed by taxpayers that are inconsistent with the forms and instructions provided by the Service. Under the method as set forth in 1996 forms, the deduction provided by section 164(f) is taken on line 25 of Form 1040; the deduction provided by section 1402(a)(12) is built into the calculation of self-employment tax liability on Schedule SE and is reflected in the computational step on line 4 (if Short Schedule SE is used) or line 4a or 5b (if Long Schedule SE).

The proposed methods below include one method raised by another service center. We also note that the numbering of the methods below does not correspond to the numbering used in the incoming correspondence.

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In one method (Proposed Method One), the taxpayer attempts to take a deduction equal to the amount of the deduction provided by section 1402(a)(12) in calculating business income on Schedule C for income tax purposes. The taxpayer apparently does not take the deduction for one-half of self-employment tax liability provided by section 164(f) in calculating federal income tax liability. The amount calculated under Schedule C is then treated as the net profit from Schedule C for purposes Schedule SE (i.e., line 2 on Short Schedule SE). The taxpayer then also takes the computational step reflected on line 4 (i.e., multiplying the net profit from Schedule C by .9235) in arriving at self-employment tax liability. The taxpayer's self-employment tax liability is considerably reduced under this method from the method permitted by Service forms, and also income tax liability may be reduced.

In a second method (Proposed Method Two), the taxpayer does not take an additional deduction for income tax purposes. In calculating self-employment tax liability, the taxpayer reduces trade or business income by an amount equal to the amount of the deduction provided by section 1402(a)(12) and also takes the computational step provided by line 4 of Short Schedule SE (i.e., multiplying the net profit from Schedule C by .9235). Under this method, self-employment tax liability is considerably reduced from the amount calculated on Service forms.

In another method (Proposed Method Three), a taxpayer has proposed that, if the taxpayer has no income tax liability, the taxpayer should be able to take the deduction allowed by section 164(f) in computing self-employment tax liability. Under this method of computation, the taxpayer would take both the deduction allowed by section 164(f) and the deduction allowed by section 1402(a)(12) in computing self-employment tax liability. No deduction would be taken in computing income tax liability, because the section 164(f) deduction does not reduce the taxpayer's income tax liability. This method also reduces self-employment tax liability for the taxpayer from the amount calculated on Service forms.

Discussion

Section 164(f)(1) provides that, in the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one half of the taxes imposed by section 1401 for such taxable year.

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Section 164(f)(2) provides that, for purposes of this chapter [i.e., Chapter 1 - Normal Taxes and Surtaxes], the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

Before the 164(f) amount can be determined, a taxpayer must first compute the amount of the self-employment taxes imposed. The self-employment taxes are imposed under section 1401. Self-employment taxes are a specified percentage (15.3% for 1996) of an individual's "net earnings from self-employment." Under the first sentence of section 1402(a), net earnings are generally computed by subtracting trade or business deductions attributable to the business from the self-employed individual's gross income derived from that trade or business, subject to certain deductions and adjustments enumerated in section 1402(a).

Section 1402(a)(12) provides that in computing gross income and deductions and distributive share of partnership ordinary income or loss for purposes of determining net earnings from self-employment:

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.

As an initial matter, there seems to be confusion concerning whether the Schedule SE incorporates the deduction provided by section 1402(a)(12). Therefore, we will attempt to show how the deduction is built into the Schedule SE. The deduction provided by section 1402(a)(12) is taken by the taxpayer when the taxpayer performs the computational step of multiplying .9235 by trade or business income on line 4 of the 1996 Short Schedule SE or on lines 4a and 5b of Long Schedule SE. The .9235 figure is derived by subtracting one half of the sum of the rates imposed by section 1401(a) and (b) from 1. The sum of the section 1401(a) and (b) rates is 15.3 percent for 1996. One half of that sum is 7.65 percent. To determine the section 1402(a)(12) deduction, that 7.65 percent is multiplied by the net earnings from self-

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employment calculated without regard to the section 1402(a)(12). After subtracting the deduction allowed by section 1402(a)(12), the taxpayer is left with his or her net earnings from self-employment, which will equal 92.35 percent of the net earnings from self-employment calculated without regard to section 1402(a)(12). Thus, the computational step of multiplying trade or business income by .9235 provides the taxpayer with the deduction provided by section 1402(a)(12).

Algebraically, this can be expressed as follows, where m equals the taxpayer's net earnings from self-employment without regard to the section 1402(a)(12) deduction.

$$\begin{aligned} \text{Section 1402(a)(12) deduction} &= m \times 1/2 (.1240 + .029) \\ &= m \times .0765 \\ &= .0765 m \end{aligned}$$

The taxpayer's net earnings from self-employment equals m less the section 1402(a)(12) deduction, since m equals the net earnings from self-employment before taking the section 1402(a)(12) deduction. Expressed algebraically,

$$\begin{aligned} \text{Net earnings from self-employment} &= m - .0765m \\ &= .9235 m \end{aligned}$$

This is exactly the computation that is reflected on the Schedule SE. Thus, the section 1402(a)(12) deduction is built into the Schedule SE computation, and taxpayers cannot take an additional deduction based on section 1402(a)(12).

The purpose of the section 1402(a)(12) and section 164(f) deductions is to place individuals who are subject to self-employment tax in parity with those who are subject to the Federal Insurance Contributions Act (FICA) tax.

In computing "net earnings from self-employment," section 1402(a)(12) of the Code allows a deduction equal to a taxpayer's net earnings (disregarding section 1402(a)(12)) multiplied by one-half of the sum of the old-age, survivors, and disability insurance tax rate and the hospital insurance rate. Section 1402(a)(12) provides that the deduction is "in lieu of the deduction provided by section 164(f)." We interpret this to mean that solely for purposes of computing net earnings from self-employment, the section 1402(a)(12) deduction is "in lieu of" the trade or business deduction (equal to the amount computed under

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section 164(f)) that would otherwise have been allowed under the first sentence of section 1402(a).

Section 1402(a)(12) breaks the circular calculation that would occur if net earnings were initially determined for SECA tax purposes, providing a tentative section 164(f) deduction, which, in turn, would be used as a deduction attributable to the trade or business in the first sentence of 1402(a), generating a new net earnings figure. The deduction under section 1402(a)(12) does not cancel the deduction under section 164(f) which is available for income tax purposes; instead, it is used merely as a computational adjustment to net earnings "in lieu of" using the section 164(f) amount as a trade or business deduction to adjust net earnings under the first sentence of section 1402(a).

We considered and rejected an alternative interpretation of the phrase "in lieu of" - that the taxpayer can choose either the deduction for self-employment purposes under 1402(a)(12) or the income tax deduction under section 164(f). Section 1402(a)(12) does not give the self-employed person a choice between the deductions. It unequivocally provides that section 1402(a)(12) is in lieu of the section 164(f) deduction. If the phrase "in lieu of" is interpreted to cancel the income tax deduction under section 164(f), the taxpayer cannot make an election to disregard section 1402(a)(12) in order to take a deduction under section 164(f).

The three proposed methods as described in the Facts are not permissible methods of taking the section 164(f) and section 1402(a)(12) deductions. The positions set forth in the Service's publications and forms as to the computation of self-employment tax liability are correct.

The first two proposed methods do not reflect the fact that taxpayers are getting the benefit of the section 1402(a)(12) deduction simply by following the method on the Schedule SE for computing liability. These two proposed methods would give taxpayers the section 1402(a)(12) deduction twice.

Under Proposed Method One, the taxpayer proposes to take the deduction provided by section 1402(a)(12) on Schedule C and for income tax purposes. However, the deduction provided by section 1402(a)(12) may only be taken in computing net earnings from self-employment for self-employment tax purposes. This deduction cannot be taken in computing income tax liability under section 1. The language at the beginning of section 1402 indicates that the paragraphs of section 1402(a), such as section 1402(a)(12), apply for the computation of net earnings from self-employment in

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determining a taxpayer's self-employment tax liability. Also, the deduction provided by section 1402(a)(12) cannot be taken twice in computing self-employment tax liability. Under this method, the deduction is taken once on Schedule C and again when doing the computation on Schedule SE as described above (i.e., multiplying trade or business income by .9235 to arrive at net earnings from self-employment).

Under Proposed Method Two, the taxpayer would also be taking the section 1402(a)(12) deduction twice. There is no authority providing that the taxpayer can take the section 1402(a)(12) deduction twice.

With regard to Proposed Method Three, the deduction allowed by section 164(f) is reflected on line 25 of Form 1040 and correctly reflects the fact that the deduction may be taken only in computing income tax liability. There is no option to deduct the deduction provided by section 164(f) in computing net earnings from self-employment. The only deduction that may be made in computing net earnings from self-employment is the deduction provided by section 1402(a)(12).

The section 1402(a)(12) deduction is "in lieu of" the deduction provided by section 164(f). The words "in lieu of" mean "in place of" or "instead of." Thus, under section 1402(a)(12) in computing net earnings from self-employment, in place of the deduction provided by section 164(f), there "shall be allowed" a deduction computed under section 1402(a)(12). The language "in lieu of" means that the taxpayer does not get the deduction provided by section 164(f) in calculating net earnings from self-employment, but instead gets the deduction provided by section 1402(a)(12). The requirement that, for self-employment tax purposes, the deduction must be taken as computed under section 1402(a)(12) is supported by the language "shall be allowed." There is nothing in the language of the Code that gives a taxpayer the option as to whether to take the section 164(f) deduction or the section 1402(a)(12) in computing net earnings from self-employment. The taxpayer is required to use the deduction calculated under section 1402(a)(12) in computing net earnings from self-employment (i.e., the product of the taxpayer's net earnings from self-employment and one-half of the sum of the rates imposed under subsections 1401(a) and (b)). Proposed Method Three would in effect interpret the section 1402(a)(12) language "in lieu of" as "in addition to", which is not consistent with the meaning of "in lieu of."

The principle that the deduction provided by section 164(f) may only be taken in computing income tax liability (and not

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self-employment tax liability) is consistent with the legislative history of this provision. The Conference Report in connection with the Social Security Amendments of 1983, 1983-2 C.B. 309, which enacted section 164(f) and 1402(a) into the Code, stated as follows:

b. Effective in 1990 and thereafter, the credit [against self-employment tax liability] would terminate and be replaced with a system designed to achieve parity between employees and the self-employed. Under this system:

1. The base of the self-employment tax would be adjusted downward to reflect the fact that employees do not pay FICA tax on the value of the employer's FICA tax.

2. A deduction would be allowed for income tax purposes, for half of SECA Liability, to allow for the fact that employees do not pay income tax on the value of the employer's FICA tax.

H. R. Rep. No. 98-47, 98th Cong., 1st Sess. (1983) at 126, 1983-2 C.B. 342.

This legislative history indicates that the deduction provided by section 164(f) for one half of SECA tax liability was intended to be a deduction for income tax purposes only. This deduction is designed to allow for the fact that employees do not pay income tax on the value of the employer's FICA tax. An employee who owes no income tax (or who would owe no income tax if the value of the employer's payment of FICA tax were added to his or her gross income) gets no benefit from the fact that employees do not pay income tax on the value of the employer's FICA tax. Similarly, a self-employed person who owes no income tax should derive no benefit from the deduction provided by section 164(f).

In summary, our position is that sections 164(f) and 1402(a)(12) of the Code are separate deductions available to all individuals who are subject to self-employment taxes. The deduction under section 164(f) is taken above the line and is available for income tax purposes only. The deduction under section 1402(a)(12) is available only for determining net earnings from self-employment and is built into the calculation of self-employment tax liability on the current Schedule SE.

This interpretation is consistent with current Service forms, instructions, and other guidance. We find no support for

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the proposed computation methods in the statute or legislative history.

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If you have any question about this memorandum, please contact Al Kelley at (202) 622-6040.

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