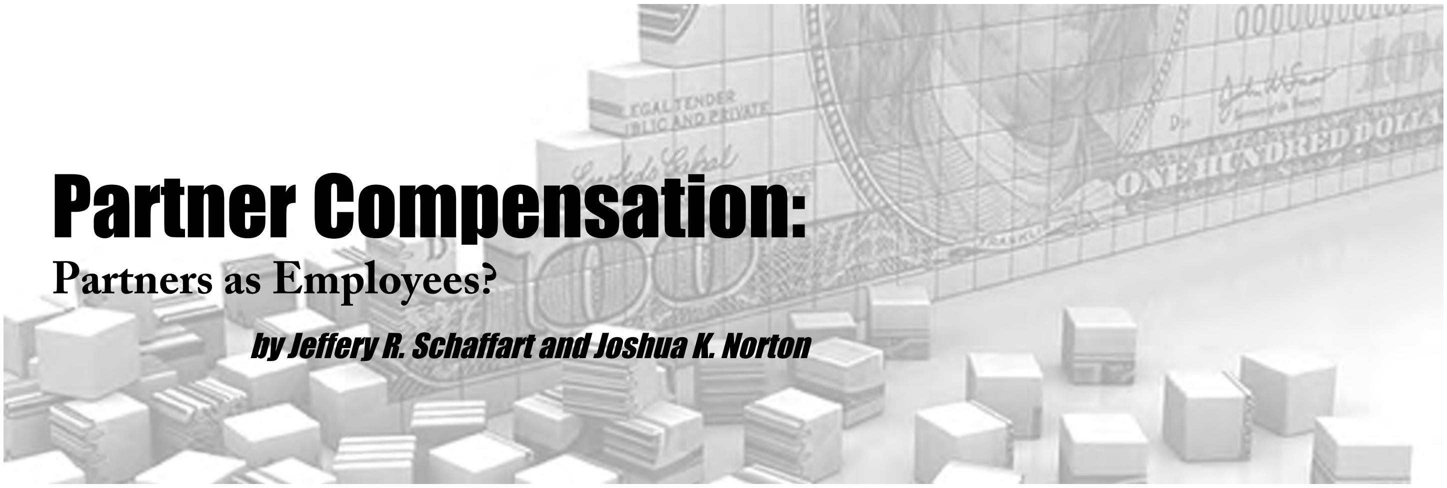

Partner Compensation:

Partners as Employees?

by Jeffery R. Schaffart and Joshua K. Norton

Attorneys frequently structure businesses as limited liability companies that are taxed as partnerships for federal income tax purposes. This structure is often compelling because it combines limited liability for state law purposes with flow-through taxation for federal income tax purposes. Unlike subchapter S corporations (which also combine limited liability and flow-through taxation), limited liability companies taxed as partnerships for federal income tax purposes do not face ownership restrictions and allow for flexible allocations of profits and losses. These attributes make limited liability companies taxed as partnerships for federal income tax purposes very attractive to private equity sponsors and other institutional investors.

It is also very common for limited liability companies that are taxed as partnerships for federal income tax purposes to have owners who provide services to the company. For example, two or more individuals may form and work for such an entity. In addition, the owners of such an entity, especially private equity firms, may desire to incent the company's management with equity.

In these situations, one of the first planning issues to consider is whether the owners who provide services to the company should be treated as self-employed partners or as employees. Although many entities taxed as partnerships for federal income tax purposes may treat their owners who provide services as employees for simplicity and because the service providers often prefer this treatment, under Rev. Rul. 69-184, it has long been the rule that "[b]ona fide members of a partnership are not employees of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages. . . . Such a partner who devotes his time and energies in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual."[1]

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Historically, Internal Revenue Service ("IRS") enforcement regarding misclassifying partners as employees has been relatively lax. Recent guidance focused on this issue, however, may signal that the IRS will more actively enforce the rule that an individual may not be both an employee and a partner of the same entity.

This article first reviews the general federal income tax consequences of a service provider being treated as an employee and as a partner. Second, it reviews some risks of misclassifying partners as employees. It then discusses recent IRS rulemaking that eliminated the employee of a disregarded entity planning strategy for addressing the dual partner and employee issue. Finally, this article reviews planning strategies that attorneys may use to address the dual partner and employee issue.

I. Employee and Partner Consequences

A. General Consequences of Employee Status

Service providers who are treated as employees have their compensation reported on an IRS Form W-2. As such, the employer is required to withhold federal and state income taxes and the employee's portion of Federal Insurance Contributions Act ("FICA") taxes from the employee's wages. The FICA tax is comprised of two elements: old-age, survivor and disability insurance ("OASDI") and health insurance ("Medicare"). For 2017, the FICA OASDI tax imposed on both the employee and employer is equal to 6.2% of the employee's first $127,200 in wages.[2] For 2017, the FICA Medicare tax imposed on both the employee and employer remains uncapped and is equal to 1.45% of the employee's wages, except that an employee's FICA Medicare tax rate on wages in excess of $200,000 ($250,000 for a joint return) is increased by 0.9% to 2.35%.[3] Wages paid to employees are also subject to taxes under the Federal Unemployment Tax Act ("FUTA").[4] Applicable FUTA taxes are paid solely by the employer.

In addition, employees are eligible to receive a number of tax advantaged employment benefits. For example, the following employee benefits are excluded from federal income and FICA taxes:

- Health care costs, including payments of insurance premiums, paid by the employer for an employee, the employee's spouse and the employee's dependents;[5]
- Matching contributions to 401(k) plans and other qualified retirement plans paid by the employer (although amounts attributable to these contributions will be taxable to the employee when distributed);[6]
- Amounts employees contribute to cafeteria plans, such as flexible spending accounts;[7] and
- Employer-provided educational assistance benefits up to $5,250.[8]

B. General Consequences of Partner Status

Service providers who are treated as partners are considered self-employed and their compensation is reported on an IRS Schedule K-1. A company taxed as a partnership is not required or allowed to withhold amounts for federal income or self-employment taxes from a partner. Instead, the partner must make quarterly estimated tax payments.

The Self-Employment Contributions Act ("SECA") imposes self-employment taxes on self-employment income. SECA, like FICA, is comprised of two elements: OASDI and Medicare. For 2016, the SECA OASDI tax imposed on a self-employed individual is equal to 12.4% of the first $127,200 of self-employment income.[9] For 2017, the uncapped SECA Medicare tax imposed on a self-employed individual is equal to 2.9% of the first $200,000 ($250,000 for a joint return) of self-employment income.[10] A self-employed individual's SECA Medicare tax is increased by 0.9% to 3.8% on self-employment income in excess of $200,000 ($250,000 for a joint return).[11] A self-employed individual may generally deduct one-half of the individual's self-employment tax liability because employees are not taxed on their employer's FICA contributions.[12] The deduction for one-half of self-employment taxes does not apply to the 0.9% additional SECA Medicare tax imposed on self-employment income in excess of $200,000 ($250,000 for a joint return).[13]

Partners can participate in most benefit plans that employees can, with a few exceptions. With respect to health insurance plans, partners may participate in company-provided health insurance plans. Health insurance premiums that a company pays for the benefit of a service provider partner are, however, a guaranteed payment. A partner can generally take a federal income tax deduction equal to any company paid insurance premium.[14] These premiums are, unlike premiums paid on behalf of an employee which are not subject to FICA taxation, subject to SECA taxation. In addition, a partner, unlike an employee, cannot make pre-tax contributions to a cafeteria plan, such as by making pre-tax contributions to a flexible spending account.

With respect to 401(k) plans and other qualified retirement plans, a partner may generally participate in these plans. A company contribution to a 401(k) plan on a partner's behalf is treated as a guaranteed payment. A partner can generally take a federal income tax deduction equal to any company match.[15] These contributions are, unlike contributions made on behalf of an employee which are not subject to FICA taxation, subject to SECA taxation. The upshot of these health insurance and retirement plan contribution rules is that a partner does not pay federal income tax on these amounts, but must pay SECA taxes on these amounts.

Employer-provided educational assistance is an example of a benefit program that is available to employees, but not partners.

C. Employee vs. Partner Example

The following tables summarize the FICA and SECA differences between employee status and partner status. They assume that $400,000 in annual compensation is paid for services. They also assume that the company makes a 401(k) matching contribution of $15,900 and that the company makes a $20,000 health insurance premium payment for the service provider.

Employee FICA Consequences:			
Income	**Employee's Payment**	**Company's Payment**	**Total**
First $127,200[16]	$9,730.80	$9,730.80	$19,461.60
$127,200 - $200,000[17]	$1,055.60	$1,055.60	$2,111.20
$200,000 - $400,000[18]	$4,700.00	$2,900.00	$7,600.00
Total	**$15,486.40**	**$13,686.40**	**$29,172.80**

Partner SECA Consequences:			
Income	**Partner's Payment**	**Company's Payment**	**Total**
First $127,200[19]	$19,461.60	$0.00	$19,461.60
$127,200 - $200,000[20]	$2,111.20	$0.00	$2,111.20
$200,000 - $400,000[21]	$7,600,00	$0.00	$7,600,00
$400,000- $435,900[22]	$1,364.20	$0.00	$1,364.20
Total	**$30,537.00**	**$0.00**	**$30,537.00**

The total self-employment SECA taxes paid by the partner exceeds the total employment taxes paid by the employee and employer in the above examples by $1,364.20 because the $35,900 in health insurance premiums and 401(k) match are subject to SECA, but are not subject to FICA.

II. Potential Risks of Misclassifying Partners as Employees

Service providers frequently prefer to be treated as employees instead of partners because of the inconvenience and complexity of making quarterly estimated tax payments and because of the additional SECA taxes that partners pay. Service providers also generally prefer to be treated as employees because partners must include benefits in taxable income, although for most benefits an offsetting income tax (but not SECA tax) deduction will apply. As IRS enforcement has historically been lax in this area, many partnerships have treated partners who are service providers as employees. There are, however, several potential risks associated with misclassifying a partner who is a service provider as a partner. These risks include:

• **Rev. Proc. 2001-43, relating to profits interests, may not apply**. To qualify for the safe harbor under Rev. Proc. 2001-43, a recipient of an unvested profits interest must be treated as a partner from the date of grant. Failing to qualify for the safe harbor may result in the profits interest being taxed on its fair market value as of the vesting date and jeopardize the ability of the recipient of an intended profits-interest grant to qualify for favorable capital gains treatment on an exit transaction.

• **Cafeteria plans may by disqualified**. Allowing a partner to participate in a cafeteria plan could lead to the plan being disqualified, which may adversely impact other participants.

• **Substantial-authority rules may be violated**. Positions taken by taxpayers on tax returns must be supported by substantial authority, or there must be a reasonable basis for the tax position that the taxpayer discloses on an IRS Form 8275 Disclosure Statement.[23] Taking the position that a partner who provides services is an employee may lead to a substantial-authority rule violation. Similar rules apply to tax return preparers,[24] which likewise may be violated if a partner who provides services is treated as an employee.

• **State tax apportionments could be disallowed**. If a partner is treated as an employee, income may not be properly apportioned to the states in which the partnership derives revenue. This could lead to state taxation authorities challenging or disallowing state tax apportionments.

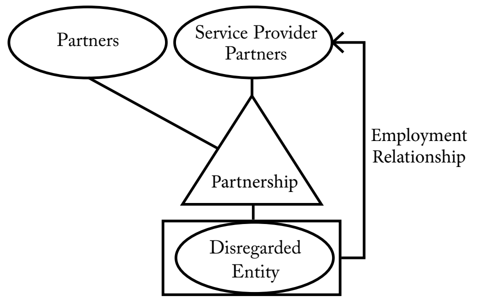
• **Benefits paid to a partner (which are taxable) may be misreported**. Benefits paid to or on behalf of a partner, such as 401(k) plan matching contributions and health insurance premiums, should be treated as a guaranteed payment and reported on IRS Schedule K-1. Treating a partner as an employee may lead to these taxable benefits being reported improperly.

• **FICA deductions may be overstated**. If a partnership treats a partner as an employee, improperly withholds FICA taxes on the partner's earnings, and takes a deduction for the portion of the FICA tax paid on the partnership's behalf, the partnership will have overstated its FICA deductions.

• **Bonuses may be taxable in the prior year**. Bonuses paid to an employee are included in taxable income in the year paid. For example, if an employee is paid a bonus in January 2017 based on the employer's 2016 income, the employee would include this bonus in taxable income in 2017. A partner, however, paid a bonus in January 2017 based on the partnership's 2016 income, would include this bonus in taxable income in 2016. Accordingly, if a partner is treated as an employee, the partner may fail to properly include bonuses in taxable income for the prior year.

III. Recent IRS Rulemaking

As a planning technique to allow owners to be treated as employees, many partnerships form subsidiary limited liability companies, known as disregarded entities, to employ the service providers. A diagram of this structure is depicted below.



Under Reg. Section 301.7701-2(c)(2)(iv), a disregarded entity is treated as a corporation with respect to taxes imposed by Subtitle C – Employment Taxes and Collection of Income Tax. Prior to the promulgation of the new proposed and temporary regulations, the only example in the applicable regulations related to a disregarded entity was one owned by an individual, and there was no example dealing with one owned by a partnership. This created a gray area and some practitioners concluded that it was permissible to treat service providers who were compensated by a disregarded entity owned by the partnership as employees of the disregarded entity.

On May 3, 2016, the IRS issued proposed and temporary regulations under Reg. Section 301.7701-2 that clarified the self-employment tax treatment of partners in a partnership that owns a disregarded entity and foreclosed the possibility of using this planning technique.[25] The preamble to the proposed and temporary regulations notes, "It has come to the attention of the Treasury Department and the IRS that even though the regulations set forth a general rule that an entity is disregarded as a separate entity from the owner for self-employment tax purposes, some taxpayers may have read the current regulations to permit the treatment of individual partners in a partnership that owns a disregarded entity as employees of the disregarded entity because the regulations did not include a specific example applying the general rule in the partnership context."[26]

The proposed and temporary regulations apply as of the later of:

• August 1, 2016; or

• The first day of the latest-starting plan year following May 4, 2016, of an affected plan.[27]

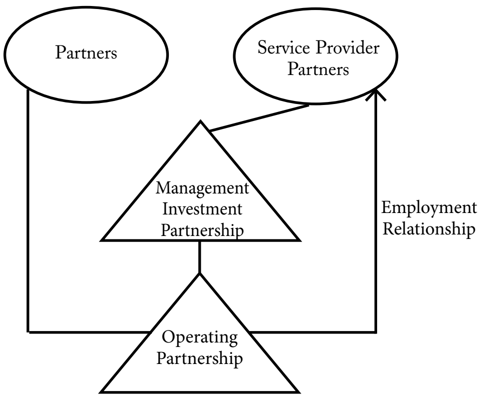
The proposed and temporary regulations did not address the applicability of Rev. Rul. 69-184 to tiered partnerships, and the IRS has requested comments on the appropriate application of the principles of Rev. Rul. 69–184 to tiered partnership situations. When publishing the proposed and temporary regulations, the IRS requested comments on the circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans and on employment taxes if Rev. Rul. 69–184 were to be modified to permit partners to also be employees in certain circumstances.

IV. Potential Planning Solutions

Although the proposed and temporary regulations take away the disregarded entity planning technique, several potential planning solutions may be available. These include tiered partnerships, S corporation holding companies, phantom equity and separate service corporations.

Tiered Partnership

In the tiered partnership structure, service providers own their interest indirectly: another partnership is interposed between the service providers and the partnership to which they provide services. In this structure, which is commonly used by private equity firms, the service providers are employees of the operating partnership and own their interest in the operating partnership indirectly through a management investment partnership. The following diagram shows how a tiered partnership may be structured.

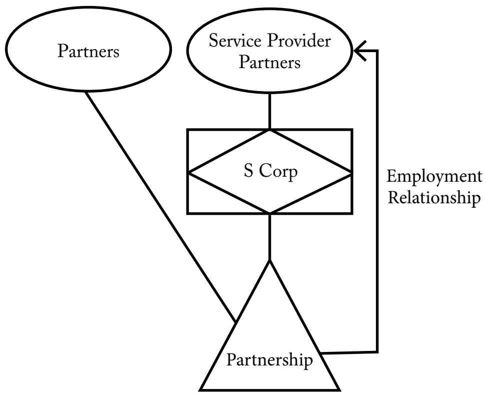


Most practitioners believe that in the above situation, it is appropriate to treat the service providers as employees of the operating partnership. Oftentimes, there may be legitimate non-tax reasons that support the business purpose of this structure that may protect it from IRS challenge. These include confidentiality concerns, as the operating partnership and its controlling owners may not want the service provider partners to have access to the operating partnership's financial results and other sensitive information. In addition, the operating partnership and its controlling owners may wish to alleviate the difficulties that arise from having a large number of owners.

The tiered partnership structure does create concerns, though. For example, additional tax returns, especially state returns, could increase compliance costs. In addition, there is risk that the IRS may challenge the indirect interest and try to recharacterize the interest in the upper-tier management investment partnership as a direct interest in the lower-tier operating partnership. Beyond this, there is risk that the IRS may change its rules. As discussed above, the IRS is seeking comments on the proper applicability of Rev. Rul. 69-184 to tiered partnerships and any rules that arise may limit or eliminate the ability to use tiered partnerships to address the dual partner and employee issue.

S Corporation Holding Company

Another potential planning solution is for the service provider to hold its partnership interest indirectly through a subchapter S corporation. The below diagram shows how a S corporation holding company may be structured.



As the S corporation is the partner instead of the service provider, the service provider should, in theory, not be treated as a partner of the partnership for self-employment tax purposes. Although it may be possible to structure the S corporation in a manner that is respected by the IRS, the IRS may challenge the structure by recasting it as a disguised sale, ignoring it, or recharacterizing it as a direct interest in the partnership, especially if the only purpose of the S corporation is to hold the partnership interest.[28]

Phantom Equity

Another potential planning solution for addressing the dual partner and employee issue is for a partnership to grant phantom equity to its service providers. Phantom equity typically provides the recipient with a contractual right to receive cash (on a pre-tax basis) equal to the amount the recipient would have received if he or she held an actual partnership interest. In this structure, the service provider is not a partner and may be properly treated as an employee of the partnership. Phantom equity, however, may fail to achieve important goals of an equity program. For example, phantom equity always generates ordinary employment income. In an exit transaction, a service provider cashed out of his or her phantom equity would pay ordinary income tax on the entire amount realized. In contrast, if a service provider sells an actual partnership interest in an exit transaction, or if a partnership sells assets in an exit transaction, the service provider may be able to recognize some of the proceeds received as long-term capital gains, which are taxed at a lower rate.

Separate Services Corporation

Another potential planning solution for addressing the dual partner and employee issue is for the partnership to create a separate service corporation to directly employ the service providers who own an interest in the partnership. The service corporation would then lease the services of the service providers to the partnership. The service corporation structure could allow the service providers to hold direct interests in the partnership and be employees of the service corporation. There is recast risk associated with this structure. Before implementing such a structure, taxpayers and their advisers should carefully consider the statutory and common law principles that the IRS and courts may use to determine whether the partnership or the services corporation controls the activities of the employees, including wage payments.

Treat Service Providers as Partners

Another potential planning solution for addressing the dual partner and employee issue is for the partnership to simply treat its service providers who provide services as partners instead of employees. For partnerships that have a small number of service provider owners and who are willing to "gross-up" their service providers for the hardship of being subject to SECA, this may be the most practical solution.

VI. Conclusion

The recent IRS rulemaking that eliminated the employee of a disregarded entity strategy for addressing the dual partner and employee issue may indicate that the IRS intends to be more proactive in enforcing Rev. Rul. 69-184. Partnerships that employ their service-provider partners as employees through disregarded entities should revisit those structures. In addition, partnerships that treat partners as employees should revisit that practice.

Endnotes

1 Rev. Rul. 69-184, 1969-1 C.B. 256.

2 IRC §§ 3101(a) and 3111(a); SSA Notice, 81 Fed. Reg. 74,854 (Oct. 27, 2016).

3 IRC §§ 3101(b) and 3111(b). There is speculation that the 0.9% additional Medicare tax imposed on employment and self-employment income above $200,000 by the Affordable Care Act may be repealed in 2017.

4 IRC §§ 3301-3311.

5 IRC §§ 105(b) and 106.

6 IRC § 402(a).

7 IRC § 125.

8 IRC § 127.

9 IRC § 1401(a); SSA Notice, 81 Fed. Reg. 74,854 (Oct. 27, 2016).

10 IRC § 1401(b)(1).

11 IRC § 1401(b)(2).

12 IRC § 164(f).

13 *Id.*

14 IRC $ 162(l).

15 This deduction is taken on Line 28 of IRS Form 1040. See IRS Publication 560.

16 On the first $127,200 of income, the employee's and employer's FICA OASDI tax rate is 6.2% each and their FICA Medicare tax rate is 1.45% each.

17 On income between $127,200 and $200,000, the employee's and employer's FICA Medicare tax rate is 1.45% each.

18 On income over $200,000 ($250,000 for joint returns) the employee's FICA Medicare tax rate is 2.35% (1.45% for the normal Medicare tax rate plus 0.9% for the additional Medicare tax rate) and the employer's FICA Medicare tax rate is 1.45%.

19 On the first $127,200 of self-employment income, the SECA tax rate is a total of 15.3% (12.4% for OASDI and 2.9% for Medicare).

20 On self-employment income between $127,200 and $200,000, the SECA tax rate is 2.9% for Medicare.

21 On self-employment income over $200,000 ($250,000 for joint returns), the SECA tax rate is a total of 3.8% (2.9% for Medicare and 0.9% for the additional Medicare tax).

22 The $35,900 of SECA income above the $400,000 "salary" is the $15,900 401(k) match and the $20,000 health insurance premium which are treated as guaranteed payments. These payments are subject to SECA at a 3.8% rate in this example.

23 IRC § 6664.

24 IRC § 6694.

25 Treasury Decision 9766, 61 F.R. 226693-266695, May 4, 2106.

26 *Id.*

27 Reg. § 301.7701–2T(8)(i).

28 *Commissioner v. Bollinger*, 485 U.S. 340 (1988); but see ABA Tax Section, Questions and Answers Relating to Section 707(a) of the Internal Revenue Code, 87 TNT 63-57, Q & A 41 (indicating that an S corporation held by a single shareholder providing services to a partnership by the individual may be recast in a manner causing section 707(a)(2)(A) to apply).