

Partners as Employees? IRS Says Not So Fast

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Last month, the Internal Revenue Service (the “IRS”) and the Treasury Department (“Treasury”) issued **final and temporary regulations** that clarify the employment tax treatment of partners in a partnership¹ that provide services to a disregarded entity owned by the partnership. The new regulations provide that the partners are treated as self-employed, rather than as employees of the disregarded entity. As a consequence, the partners are not eligible to participate in, and may be subject to less favorable tax rules for their benefits under, certain employee benefit plans.

The IRS and Treasury stated that they view the new regulations as consistent both with existing regulations and with their long-held position, enunciated in Revenue Ruling 69-184,² that an individual cannot be both a partner and an employee of a single partnership. Instead, an individual who is a partner and provides services to the partnership is treated as self-employed. In releasing the new regulations, the IRS and Treasury requested comments on:

- the appropriate application of this principle in the context of tiered partnerships; and
- circumstances in which it may be appropriate to permit a partner also to be an employee of the partnership.

The new regulations will not have retroactive effect on a partnership that currently treats partners as employees of disregarded entities owned by the partnership. Instead, the new regulations will take effect on the later of:

- August 1, 2016; or
- the first day of the latest-starting plan year following May 4, 2016 of an affected plan sponsored by a relevant disregarded entity.

Background

What is a disregarded entity?

A disregarded entity is a business entity that has a single owner and is not treated as a corporation for U.S. federal income tax purposes (e.g., a limited liability company (an “LLC”) that has not elected to be treated as a corporation for U.S. federal income tax purposes and that is a wholly owned subsidiary of another entity). For U.S. federal income tax purposes, a disregarded entity is generally not treated as a separate entity from its owner. Rather, a disregarded entity is treated as a sole proprietorship, branch or division of its owner.

What is the existing treatment of employment taxes for the owner of a disregarded entity?

Treasury regulations provide an exception to the foregoing rule in the case of employment taxes. Specifically, for employment tax purposes, a disregarded entity is generally treated as a corporation and

¹ As used in this memorandum, the term “partnership” means an entity that is treated as a partnership for U.S. federal income tax purposes (including a limited partnership or limited liability company that has more than one member and that has not elected to be treated as a corporation for U.S. federal income tax purposes).

² 1969-1 C.B. 256.

therefore as an entity separate from its owner. As a consequence, the disregarded entity, rather than its owner, is generally considered to be the employer of the entity's employees for these purposes.

This rule does not apply, however, for purposes of self-employment taxes. Under existing regulations, an individual who owns a disregarded entity and performs services for that entity is generally subject to tax on self-employment income. The existing regulations include an example that illustrates how the rule works in the context of a single-individual owner. In the example, the disregarded entity is subject to employment tax for employees of the disregarded entity, but the individual owner is subject to self-employment tax on the individual's net earnings from self-employment with respect to the disregarded entity's activities. The existing regulations do not, however, include an example in which the individual is a partner in a partnership that, in turn, owns the disregarded entity.

What is the position of the IRS and Treasury with respect to whether a partner may also be an employee of the partnership?

As noted above, in Revenue Ruling 69-184, the IRS stated that an individual cannot be both a partner and an employee of a single partnership. Specifically, Revenue Ruling 69-184 concluded that:

- a *bona fide* member of a partnership is not an employee of the partnership for purposes of the Federal Insurance Contributions Act ("FICA"), the Federal Unemployment Tax Act ("FUTA") or income tax withholding; and
- such a partner who devotes time and energy in the conduct of the trade of business of the partnership, or in providing services to the partnership as an independent contractor, is a self-employed individual rather than a common law employee.

In the preamble to the new regulations, the IRS and Treasury reaffirmed this position and stated that they did not view the existing regulations on the treatment of disregarded entities for employment tax purposes as altering the holding of Revenue Ruling 69-184.

What motivated the IRS to issue the new regulations?

In the preamble to the new regulations, the IRS and Treasury stated that, in the absence of a specific example addressing a disregarded entity owned by a partnership, some taxpayers have interpreted the existing regulations as permitting partners to be treated as employees of a disregarded entity owned by the partnership. The IRS and Treasury further stated that they did not intend the existing regulations to be read in this manner and do not believe that the existing regulations changed the holding of Revenue Ruling 69-184.

New Regulations

What do the new regulations clarify?

The new regulations clarify that, for purposes of self-employment tax, there is no distinction between a disregarded entity owned by an individual and a disregarded entity owned by a partnership. Accordingly, partners in a partnership that owns a disregarded entity to which the partners are providing services are not employees of the disregarded entity and are subject to the same self-employment tax rules as partners in a partnership that does not own a disregarded entity.

Do the new regulations address whether a limited partner who provides services to the partnership is subject to self-employment tax on his or her share of the partnership's income?

Section 1402(a)(13)³ provides that income subject to the self-employment tax does not include a limited partner's distributive share of partnership net income (but does include "guaranteed payments" made by the partnership as compensation for services provided by the limited partner). Treasury regulations proposed in 1997, but never finalized, would subject a limited partner's share of partnership income to the self-employment tax if the limited partner were involved in the partnership's trade or business or had authority to contract on behalf of the partnership.⁴ The new regulations do not contain any such provision or otherwise address the operation of Section 1402(a)(13).⁵

Possible Further Developments

Do the new regulations apply to a tiered partnership?

The new regulations apply only to situations in which a partnership owns a disregarded entity. They therefore do not apply to a tiered partnership situation, in which an upper-tier partnership owns an interest in a lower-tier partnership that employs individuals who are partners of the upper-tier partnership.

In the preamble to the new regulations, however, the IRS and Treasury requested comments on the appropriate application of the principles of Revenue Ruling 69-184, summarized above, to tiered partnership situations. It is therefore possible that the IRS and Treasury will publish further guidance addressing tiered partnerships. For now, the fact that the new regulations do not address tiered partnerships implies that the IRS and Treasury do not believe that current law under all circumstances prevents a partner of an upper-tier partnership from being an employee of a lower-tier partnership.

Are there any other possible further developments to the new regulations?

The IRS and Treasury also requested comments on whether there are circumstances in which it may be appropriate to permit a partner also to be an employee of the partnership, as well as comments on the impact that permitting partners also to be employees in certain circumstances may have on employee benefit plans and employment taxes. The IRS and Treasury noted that some commenters have suggested that, in particular, it may be appropriate to alter current law to permit employees of a partnership who receive only small partnership interests as employee compensatory awards to continue to be treated as employees of the partnership after they become partners. It is possible, therefore, that the IRS and Treasury will consider creating an exception to current law for this or other situations.

Implications

What should affected companies be doing now?

We would recommend that any entity that is treated as a partnership for U.S. federal income tax purposes and that owns a disregarded entity review the arrangements among the partners (including individuals who hold equity interests in the partnership through the grant of incentive awards), the partnership and the disregarded entity to ensure that partners are not being treated as employees of the disregarded

³ All "Section" references in this memorandum are to the Internal Revenue Code of 1986, as amended.

⁴ Prop. Treas. Reg. § 1.1402(a)-2(h).

⁵ The Tax Court has held that the partners of a limited liability partnership (an "LLP") were subject to self-employment tax in respect of their shares of the LLP's net income. *Renkemeyer v. Comm'r*, 136 T.C. 137 (2011). In a Chief Counsel Advice memorandum, the IRS took the same position with respect to members of an LLC.

entity. We note that it is not uncommon for an entity that is treated as a partnership for U.S. federal income tax purposes and is engaged in business activities (an “Operating Partnership”) to have one or more wholly owned subsidiaries that are disregarded entities.

How should affected partners report their compensation and pay their income taxes?

Compensation paid to partners for services rendered to the disregarded entity must be reported on a Schedule K-1 instead of a Form W-2. Also, unlike employees, who generally have their income taxes withheld by their employers, partners are not subject to income tax withholding and must instead pay estimated taxes on their income.

How should affected partners pay their employment taxes?

Ordinary employment taxes (*i.e.*, FICA and FUTA) with respect to an employee are paid in part by the employer itself and in part through withholding that the employer imposes on the employee's compensation. By contrast, partners are subject to self-employment taxes under the Self-Employment Contribution Act (“SECA”). Under SECA, partners must pay self-employment taxes on their compensation in an amount that is generally equal to the sum of the employer portion and the employee portion of the FICA taxes, and are permitted to claim a partially offsetting deduction generally equal to the amount that would have been the employer portion of the FICA taxes. The partnership does not withhold in respect of self-employment taxes.

Can affected partners participate in employee benefit plans?

Partners can participate in qualified retirement plans (*e.g.*, a Section 401(k) plan) because a partnership is considered to be the employer of its partners for purposes of qualified plans. Partners can also participate in a health plan, but, unlike employees, partners may not exclude from their income the value of benefits received under the plan (although partners may be entitled to a deduction for the cost of health insurance).

Partners are prohibited from participating in cafeteria plans, including flexible spending accounts, and in certain other tax-favored employee benefit plans (*e.g.*, qualified transportation and parking benefits). Allowing partners to participate may disqualify the plan entirely and result in a loss of tax benefits for all plan participants.

Are there alternatives to granting equity incentive awards in the form of partnership interests?

To allow employees to have their incentives awards tied to the success of a partnership without granting actual partnership interests, some Operating Partnerships adopt compensation plans that provide for “phantom” partnership interests, especially for non-management employees. The phantom partnership interest would typically provide the recipient the right to receive a cash amount equal (on a pre-tax basis) to the amount that the recipient would have received from an equivalent partnership interest, thereby allowing the recipient to avoid being treated as a partner.

Operating Partnerships should be aware, however, that phantom partnership interests, although generally equivalent economically to actual partnership interests, may not achieve all of the goals of an equity incentive program. For example, phantom interests are not capital assets, but rather entitlements to receive ordinary compensation income. By contrast, the owner of an actual partnership interest may, under certain circumstances, derive some long-term capital gains as a consequence of the ownership of the interest, particularly on a sale of the interest. In addition, unlike actual partnership interests, which are currently not subject to the onerous deferred compensation rules under Section 409A or Section 457A, phantom interests are subject to, and must be structured to comply with or be exempt from, these rules. It can be particularly challenging to structure phantom partnership interests to provide for the same event-based distributions as actual partnership interests because the distribution events (for actual partnership interests) are often not permissible payment events under Section 409A.

Timing

When will the new regulations take effect?

As noted above, the new regulations will not have retroactive effect on a partnership that currently treats partners as employees of any disregarded entity it owns. Instead, to allow adequate time for affected partnerships to make necessary payroll and benefit plan adjustments, the IRS and Treasury have delayed the application of the new regulations until the later of:

- August 1, 2016; or
- the first day of the latest-starting plan year following May 4, 2016 of an affected plan sponsored by a relevant disregarded entity.

This means that the new regulations will apply as follows for plans sponsored by a disregarded entity that were in existence on May 4, 2016:

- if the next plan year starts after August 1, 2016, the new regulations will apply on the first day of such next plan year (so for calendar-year plans, January 1, 2017); and
- if the next plan year starts on or prior to August 1, 2016, the new regulations will apply on August 1, 2016.

For partnerships that did not maintain any affected plans at the disregarded entity on May 4, 2016, the new regulations will apply on August 1, 2016.

For these purposes, an “affected plan” includes any qualified plan, health plan or Section 125 cafeteria plan if the plan benefits participants whose employment status is affected by the new regulations.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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